In the

United States Circuit Court of Appeals

For the Seventh Circuit

No. 8130

S. B. HEININGER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decision of the United States Board of Tax Appeals.

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STATEMENT OF EVIDENCE.

PETITIONER'S EXHIBITS.

1 S. B. Heininger,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket No. 106518.

Appearances:

For Taxpayer: Earl B. Wilkinson, Esq., Samuel W. Witwer, Jr.

For Comm'r: D. A. Taylor, Esq.

DOCKET ENTRIES.

1941

Feb. 26—Petition received and filed. Taxpayer notified. (Fee paid.)

Feb. 26—Copy of petition served on General Counsel.

Mar. 7—Notice of appearance of Earl B. Wilkinson and Samuel W. Witwer, Jr., as counsel filed.

Apr. 10—Answer filed by General Counsel.

Apr. 10—Request for hearing in Chicago, Illinois, filed by General Counsel.

Apr. 17—Notice issued placing proceeding on Chicago, Illinois, Calendar. Service of answer and request made.

Oct. 13—Hearing set Dec. 1, 1941, Chicago, Illinois.

Dec. 4—Hearing had before Mr. Disney on merits. Submitted. Stipulation of facts filed. Briefs due Jan. 10, 1942; Replies Feb. 1, 1942.

Dec. 18—Transcript of hearing 12/4/41 filed.

1942

Jan. 10—Brief filed by General Counsel.

Jan. 12—Brief filed by taxpayer. (O. K. Mr. Disney's Office.) 1/13/42 copy served on General Counsel.

Feb. 2—Reply brief filed by taxpayer. 2/2/42 copy served on General Counsel.

June 10—Opinion rendered, Disney, Div. 4. Decision will be entered for the respondent. 6/12/42 copy served.

June 13—Decision entered, R. L. Disney, Div. 4.

Aug. 31—Petition for review by United States Circuit Court of Appeals, Seventh Circuit, filed by taxpayer.

Aug. 31—Statement of points filed by taxpayer.

Aug. 31—Statement of evidence filed.

Sept. 3—Proof of service of filing petition for review and statement of points filed.

Sept. 28—Designation of contents of record to be included in the record filed by taxpayer.

Oct. 5—Proof of service of filing designation of record filed by taxpayer.

Filed Feb. 26, 1941.

2 BEFORE THE UNITED STATES BOARD OF TAX APPEALS.

S. B. Heininger, *Petitioner,*
vs.
Commissioner of Internal Revenue, *Respondent.*
} Docket No. 106518.

PETITION.

Filed Feb. 26, 1941.

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols SN:IT:1) dated December 3, 1940, and, as a basis of his proceeding, alleges as follows:

1. The petitioner is an individual residing at 1432 North La Salle Street, Chicago, Cook County, Illinois. The returns for the periods here involved were filed with the Collector for the First District of Illinois, at Chicago, Illinois.

2. The notice of deficiency, copy of which is attached hereto and marked Exhibit A, was mailed to petitioner on December 3, 1940, as petitioner believes.

3. The taxes in controversy are income taxes for the calendar years 1937 and 1938, and the proposed assessments are in the aggregate amount of $15,176.01, with interest as provided by law.

3 4. The determination of the tax against petitioner, as set forth in said notice of deficiency, is based upon the following errors:

Relating to the Calendar Year 1937.

(a) The Commissioner of Internal Revenue erroneously found that deposits on orders for artificial dentures unfilled as at December 31, 1937, aggregating $20,593.60, received by petitioner from customers during 1937, were taxable in the year of receipt and that petitioner's income for 1937 should be increased in said amount.

(b) The Commissioner erred in failing to find and determine that petitioner did not earn or become entitled to said deposits of $20,593.60, in the year 1937; that the Commissioner should have found and determined that not until the calendar year 1938, when petitioner filled certain of said orders and shipped artificial dentures to certain depositors did petitioner earn and become entitled to any part of said deposits or did any part thereof become income of petitioner.

(c) The Commissioner erred in failing to find and determine that under contract of sale with each depositor petitioner had no enforceable claim to said deposits of $20,593.60 at any time during the year 1937; that the Commissioner should have found and determined that said depositors had an unconditional right throughout 1937 to a refund and restoration of all of said deposits aggregating $20,593.60, and, accordingly, that it was impossible to determine in 1937 whether any part of said deposits constituted or would ever constitute income of petitioner.

(d) The Commissioner erroneously found and de-
4 termined that $7,706.99 paid by petitioner in 1937 for attorneys' fees in defending a proceeding instituted by the Postmaster General of the United States under 39 U. S. C. A. Section 259 and 732, to deprive petitioner of the use of the mails in his business, was not deductible from an income as an ordinary and necessary business expense.

(e) The Commissioner erred in failing to find and determine that said payment of $7,706.99 for attorneys' fees made by petitioner in the year 1937 was an ordinary and necessary business expense and deductible from income in the year 1937.

(f) The Commissioner erroneously determined and assumed that said attorneys' fees of $7,706.99 paid by petitioner in 1937 were for legal services in defense of a criminal charge, and erroneously determined and assumed for

said reason that said attorneys' fees were not deductible from income in 1937.

(g) The Commissioner erroneously determined and assumed that the said proceeding instituted by the Postmaster General of the United States against petitioner under U. S. C. A. Sections 259 and 732 and petitioner's suit to enjoin the enforcement of a "fraud order" issued by the Postmaster General, established that the petitioner's business in 1937 was unlawful; that the Commissioner should have found and determined that even if petitioner's business in 1937 were unlawful (which is hereby expressly denied) petitioner was entitled to deduct from income in 1937, as an ordinary and necessary expense of continuing and maintaining said business the said payment of $7,706.99 for attorneys' fees.

Relating to the Year 1938

(h) The Commissioner of Internal Revenue erroneously found and determined that deposits on orders for artificial dentures, unfilled as at December 31, 1938, aggregating $6,900.63 and received by petitioner from customers during 1938, were taxable in the year of receipt, and that petitioner's income for 1938 should be increased in said amount.

(i) The Commissioner erred in failing to find and determine that petitioner did not earn or become entitled to the said deposits of $6,900.63 as his own property in the year 1938, and that Commissioner should have found and determined that not until the calendar year 1939, when petitioner filled certain of said orders and shipped artificial dentures to certain depositors did petitioner earn and become entitled to any part of said deposits or did any part thereof become income of petitioner.

(j) The Commissioner erred in failing to find and determine that under contract of sale with each depositor petitioner had no enforceable claim to said deposits of $6,900.63 at any time during the year 1938; that the Commissioner should have found and determined that said depositors had an unconditional right throughout 1938 to a refund and restoration of all of said deposits aggregating $6,900.63, and, accordingly, that it was impossible to determine in 1938 whether any part of said deposits constituted or would ever constitute income of petitioner.

(k) The Commissioner erroneously found and determined that the sum of $29,530.56 paid by petitioner in 1938 for attorneys' fees in defending a proceeding instituted by
the Postmaster General of the United States, under
6 39 U. S. C. A. Sections 259 and 732, and which resulted in the issuance of a "fraud order" in 1938 and in prosecuting a suit in the District Court of the United States for the District of Columbia, to enjoin the enforcement of said order, was not deductible from income in 1938 as an ordinary and necessary business expense.

(l) The Commissioner erred in failing to find and determine that said payment of $29,530.56 by petitioner in the year 1938 for attorneys' fees was an ordinary and necessary business expense and deductible from income in 1938.

(m) The Commissioner erroneously determined and assumed that said attorneys' fees of $29,530.56 paid by petitioner in 1938 were for legal services in defense of a criminal charge, and erroneously determined and assumed for said reason that said attorneys' fees were not deductible from income in 1938.

(n) The Commissioner erroneously determined and assumed that the said proceeding instituted by the Postmaster General of the United States against petitioner under U. S. C. A. Section 259 and 732, and petitioner's suit to enjoin the enforcement of a "fraud order" issued by the Postmaster General, established that the petitioner's business in 1938 was unlawful; that the Commissioner should have found and determined that even if petitioner's business in 1938 were unlawful (which is hereby expressly denied) petitioner was entitled to deduct from income, as an ordinary and necessary expense of continuing and maintaining said business, the said payment of $29,530.56 for attorneys' fees.

(o) If deficiencies are assessed for the years 1937
7 and 1938, as proposed by the Commissioner, such action will be contrary to the provisions of the applicable Revenue Acts and in violation of the 5th and 16th Amendments to the Constitution of the United States.

5. The facts upon which petitioner relies as the basis of this proceeding are as follows:

The Facts With Reference to the Deposits on Unfilled Orders.

(a) During 1937 and 1938, petitioner's business consisted solely of the sale by mail of artificial dentures made by petitioner in Chicago, Illinois. During said years, petitioner advertised nationally, and upon receiving an inquiry from a prospective customer, petitioner mailed to him certain "first impression" material with instructions for use, and an order form suggesting remittance, with the order of a deposit of $2.00. Upon receipt of the order, deposit and "first impression" material from the customer, petitioner forwarded to the customer certain "trays" with detailed instructions for taking additional mouth impressions. If the second impressions made on these "trays" proved unsatisfactory, new impression material was forwarded the customer, or in lieu thereof, the deposit was refunded when requested. The cost to petitioner of the "first impression" material and "trays" was a negligible part of the cost of the completed artificial denture. When impressions were approved by petitioner, then artificial dentures were constructed by petitioner and shipped C. O. D. to the customer for the balance of the price.

(b) To a large extent, the deposits of $20,593.60 and $6,900.63, held by petitioner at the close of the calendar years 1937 and 1938, respectively, represented the deposits received in the closing months of said years, respectively. Considerable time elapsed on the average order between the receipt of the deposit and the actual construction and shipment of the dentures. The deposits in question were on orders which were unfilled as of the close of the year in which the same were received by petitioner. On these orders no dentures were constructed and shipped by petitioner within the year of receipt and the respective sums deposited were neither earned by petitioner nor belonged to him by reason of any sale, as of the close of the respective calendar years. In many instances customers abandoned their purchases and requested and obtained promptly, refunds of their deposits. Petitioner entered all deposits in a "deposit account" and upon the completion of a particular sale, subsequently, he charged the "deposit account" and added the deposit on said sale to receipts.

(c) On December 31, 1937, the deposits on unfilled orders amounted to $20,593.60, of which $3,656.60 represented deposits received during the period from March 25, 1935 to December 31, 1936 on orders which were unfilled as at December 31, 1937. Said deposits of $3,656.60 were erroneously included as income in petitioner's Returns for 1935 and 1936, and claim for refund has been filed with respect to the year 1936. During 1938, petitioner constructed and shipped artificial dentures to customers on orders received in 1937 and which were unfilled as of December 31, 1937 to extent permitting release of deposits in the amount of $13,823.94. Thereupon, petitioner added said sum of $13,823.94 to receipts for the year 1938.
9 During 1938, petitioner received deposits on orders unfilled as at December 31, 1938, amounting to $6,900.63, and added said amount to the "deposit account." Accordingly, the amount of deposits on unfilled orders held by petitioner on December 31, 1938 was $13,670.29.

(d) The printed order form provided that the artificial dentures were to be sold by petitioner on the basis of a sixty-day trial by the customer. The customer reserved the unconditional right to return the false teeth and recover his entire payment, including his deposit, at any time within sixty days following the delivery to him of the dentures. Many customers exercised their right of refund, both before and after construction and shipment of the artificial dentures, and the petitioner promptly restored to such customers the amounts deposited. With respect to the deposits in question in the years 1937 and 1938, no artificial dentures were constructed and shipped on said orders within the respective years in which said deposits were received and whether or not such deposits would ever constitute taxable income to petitioner could not be determined in the respective years of receipt.

(e) During part of 1937 and throughout 1938 petitioner defended a proceeding instituted by the Postmaster General of the United States to deprive petitioner of the use of the mails. During the pendency of said proceeding, petitioner was faced with the possibility that a "fraud" order might be entered and his business be terminated over-night. This condition with the other factors mentioned made it imposible to determine in the respective
10 years of receipt whether said deposits constituted or would ever constitute income.

The Facts Regarding the Right to Deduct From Income the Attorneys' Fees Paid by Petitioner During the Years 1937 and 1938.

(f) On September 22, 1937, a citation was issued by the Solicitor of the Post Office Department, charging that petitioner's business constituted a scheme for obtaining funds through the mails by means of false and fraudulent pretenses, in violation of 39 U. S. C. A. Sections 259 and 732. Thereafter, petitioner answered said charges and employed attorneys in resisting said proceeding. Petitioner paid said attorneys in 1937 fees amounting to $7,069.99.

(g) On February 19, 1938, the Postmaster General of the United States issued a "fraud order" forbidding the Postmaster at Chicago, Illinois, to pay any money orders drawn to the order of petitioner, and instructing sad Postmaster to return all mail addressed to the petitioner, marked "Fraudulent". Thereupon, petitioner filed suit in the District Court of the United States for the District of Columbia against James A. Farley, Postmaster General, and on that date said court entered an order directing the Postmaster General to hold all mail addressed to petitioner until the further order of Court.

(h) On June 3, 1938, the District Court of the United States for the District of Columbia granted to petitioner a permanent injunction and found that the "fraud order" of February 19, 1938 was null and void, and that the plaintiff was engaged in a lawful business. Thereafter, the Postmaster General appealed to the United States
11 Court of Appeals for the District of Columbia, and on April 17, 1939 that Court reversed the order of the District Court for the District of Columbia and remanded the cause with instructions to dissolve the injunction and to dismiss the Bill of Complaint (105 Fed. 2nd. 79). In its opinion, the Court of Appeals made no finding that the petitioner was engaged in a fraudulent business, but held that the only question before it was whether the conclusion of the Postmaster General was supported by "substantial" evidence, which the Circuit Court found to be the case. Thereafter, in 1939 the petitioner applied to the Supreme Court of the United States for a Writ of Certiorari to review the judgment of the United States Court of Appeals, which petition was denied. Petitioner has not since engaged in business of selling artificial dentures.

(i) During 1938, petitioner paid $29,530.56 for legal services in resisting the proceeding brought by the Postmaster General which culminated in the "fraud order", in prosecuting his injunction suit in the District Court of the United States for the District of Columbia and defending the said appeal of the Postmaster General to the Circuit Court of Appeals for the District of Columbia.

(j) If petitioner had not engaged attorneys and expended said sums in 1937 and 1938, he would have been forced to discontinue his business on February 19, 1938, and there would have been no net income of petitioner in 1938 upon which to pay an income tax. Said payments of attorneys' fees were not only ordinary and necessary business expenses but they were essential to the continuance of petitioner's business in the years 1937 and
12 1938 and were proximately related to said business.

Wherefore, petitioner prays that this Board hear this proceeding and redetermine the alleged deficiency and find and adjudge that said deficiency proposed by the Commissioner of Internal Revenue with respect to the years 1937 and 1938 is without foundation in fact and law.

S. B. Heininger.

Earl B. Wilkinson,
Floyd L. Lanham,
Samuel W. Witwer, Jr.,
231 S. La Salle Street,
Chicago, Illinois.

13 State of Illinois, } ss.
County of Cook. }

S. B. Heininger, being first duly sworn, on oath deposes and says that he is the subscriber to the foregoing petition; that he has read the foregoing petition and is familiar with the statements contained therein, and that the statements therein made are true.

S. B. Heininger.

Subscribed and sworn to before me this 31st day of January, A. D. 1941.

Lolita A. Conway,
Notary Public.

(Seal)

My Commission expires: March 19, 1944.

14 EXHIBIT A.

SN-IT-1

TREASURY DEPARTMENT
Internal Revenue Service
Chicago, Illinois

Form 1230 Dec. 3, 1940.

Office of
Internal Revenue Agent in Charge
Chicago Division
Room 1100, 105 West Adams Street
Mr. S. B. Heininger
706 North Hudson Street
Chicago, Illinois

Sir:

You are advised that the determination of your income tax liability for the taxable year(s) ended December 31, 1937 and 1938 discloses a deficiency of $15,176.01 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Chicago, Illinois, for the attention of SN:IT. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,
Guy T. Helvering,
Commissioner,
By (Signed) E. C. Wright,
Internal Revenue Agent in Charge.

Enclosures:
Statement
Form of Waiver
Form 272M

MA:GS

15 Statement.

SN:IT

Mr. S. B. Heininger
706 North Hudson Street
Chicago, Illinois

Tax Liability for the Taxable Years Ended December 31, 1937 and 1938.

Income Tax

Year	Liability	Assessed	Deficiency
1937	$18,521.76	$7,705.14	$10,816.62
1938	4,978.16	618.77	4,359.39
Totals	$23,499.92	$8,323.91	$15,176.01

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated November 17, 1939; to your protest dated January 20, 1940; and to the statements made at the conferences held on February 7, 1940, February 10, 1940, and May 17, 1940.

If you do not acquiesce in all of the adjustments making up the deficiency indicated, but desire to stop the accumulation of interest on that part of the deficiency resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amount of deficiency you desire to have assessed at once. The execution of the form for the agreed portion of the deficiency will not deprive you of your right to petition the United States Board of Tax Appeals for a redetermination of the deficiency.

Taxable Year Ended December 31, 1937.
Adjustments to Net Income.

Net income as disclosed by return	$46,952.08
Unallowable deductions and additional income	
(a) Income from business	28,300.59
Net income adjusted	$75,252.67

16 Explanations of Adjustments.

(a) Prior to 1937 you reported as income in each year all amounts received as deposits on orders for dentures which were unfilled at the close of the year. In the returns filed for the years 1937 and 1938, such amounts were omitted from income. It is held that in accordance with the provisions of Article 41-1 of Regulations 94, such amounts are taxable in the year in which received. Accordingly, your income for 1937 has been increased by $20,593.60.

It is held that the amount of $7,706.99 paid by you in the year 1937 for legal expenses is not deductible from income. The amount was expended in defense of a proceeding brought against you by the Postmaster General of the United States under authority of the laws relating to the Postal Service, which resulted in the issuance of a "desist" order in 1938, and your unsuccessful suit to enjoin its enforcement was terminated in 1939 when the Supreme Court denied certiorari.

Earned income credit claimed in your return in the amount of $936.04 has been increased to $1,400.00, the amount allowable under the provisions of sections 25(a)(3) and (4) of the Revenue Act of 1936.

Computation of Tax.

Net income adjusted		$75,252.67
Less:		
Personal exemption	$2,500.00	
Credit for dependents	800.00	3,300.00
Balance (surtax net income)		$71,952.67
Less:		
Earned income credit (10% of $14,000)		1,400.00
Net income subject to normal tax		$70,552.67
Normal tax at 4% on $70,552.67		2,822.11
Surtax on $67,952.67 (amount in excess of $4,000)		15,699.65
Total tax		$18,521.76
17 Less:		
Income tax paid at the source		None
Correct income tax liability		$18,521.76
Income tax assessed:		
Original, account No. 205471		7,705.14
Deficiency of income tax		$10,816.62

Taxable Year Ended December 31, 1938.
Adjustments to Net Income.

Net income as disclosed by return		$12,274.39
Unallowable deductions and additional income		
(a) Income from business	$22,972.83	
(b) Dividends	350.00	
(c) Loss on exchange of automobile	754.25	24,077.08
Net income adjusted		$36,351.47

Explanation of Adjustments.

(a) Prior to 1937 you reported as income in each year all amounts received as deposits on orders for dentures which were unfilled at the close of the year. In the returns filed for the years 1937 and 1938, such amounts were omitted from income. It is held that in accordance with the provisions of Article 41-1 of Regulations 101, such amounts are taxable in the year in which received. Accordingly, your income for 1938 has been decreased by $13,823.94, which represents deposits reported as income by you in that year, which should have been included in the prior year, less $6,900.63 representing deposits collected at the close of the year 1938 and now included as income in that year, or a net difference of $6,923.31.

18 It is held that the amount of $29,530.56 paid by you in the year 1938 for legal expenses is not deductible from income. The amount was expended in defense of a proceeding brought against you by the Postmaster General of the United States under authority of the laws relating to the Postal Service, which resulted in the issuance of a "desist" order in 1938, and your unsuccessful suit to enjoin its enforcement was terminated in 1939 when the Supreme Court denied certiorari.

The amount of $365.58 legal fees, included in deductions in your return, has been disallowed for the reason that it was paid for services rendered another company and, therefore, is not deductible by you under any of the provisions of section 23 of the Revenue Act of 1938.

(b) Dividends reported in your return in the amount

of $875.00 have been increased to $1,225.00, the amount received during the taxable year from the United States Steel Corporation, and taxable under the provisions of Section 22(a) of the Revenue Act of 1938.

(c) The loss claimed on line 19(c) of your return in the amount of $754.25 as sustained on an automobile, which was traded in on another automobile, has been disallowed for the reason that no loss is recognized on exchanges solely in kind, in accordance with the provisions of section 112(b)1 of the Revenue Act of 1938.

Earned income credit claimed in your return in the amount of $300.00 has been increased to $701.03, the amount allowable under the provisions of section 25(a) (3) and (4) of the Revenue Act of 1938.

Computation of Tax.

Net income adjusted		$36,351.47
Less:		
Personal exemption	$2,500.00	
Credit for dependents	466.67	2,966.67
Balance (surtax net income)		$33,384.80
Less:		
Earned income credit		701.03
Net income subject to normal tax		$32,683.77
19 Normal tax at 4% on $32,683.77		1,307.35
Surtax on $29,284.80 (amount in excess of $4,000)		3,670.81
Total normal tax and surtax		$ 4,978.16
Less:		
Income tax paid at source		none
Correct income tax liability		$ 4,978.16
Income tax assessed:		
Original, account No. 828743		618.77
Deficiency of income tax		$ 4,359.39

20 UNITED STATES BOARD OF TAX APPEALS. Filed Apr. 10, 1941.

(Caption—106518)

ANSWER.

(Filed Apr. 10, 1941.)

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed in the above-entitled cause admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. (a) to (o), incl. Denies the allegations of error contained in subparagraphs (a) to (o), inclusive, of paragraph 4 of the petition.

5. (a) and (b) Denies the allegations of fact contained in subparagraphs (a) and (b) of paragraph 5 of the petition.

5. (c) Admits that at December 31, 1937 deposits on unfilled orders received by the petitioner amounted to
21 $20,593.60 and that deposits on the unfilled orders at December 31, 1938 amounted to $6,900.63 as alleged in subparagraph (c) of paragraph 5 of the petition. Denies the remaining allegations contained in subparagraph (c) of paragraph 5 of the petition.

5. (d) Denies the allegations of fact contained in subparagraph (d) of paragraph 5 of the petition.

5. (e) Admits that during part of 1937 and throughout 1938 petitioner defended a proceeding instituted by the Postmaster General of the United States to deprive petitioner of the use of the mails. Denies the remaining allegations contained in subparagraph (e) of paragraph 5 of the petition.

5. (f) and (g) Admits the allegations contained in subparagraphs (f) and (g) of paragraph 5 of the petition.

5. (h) Admits that on June 3, 1938 the District Court of the United States for the District of Columbia granted to petitioner a permanent injunction; that thereafter the

Postmaster General appealed to the United States Court of Appeals for the District of Columbia and on April 17, 1939 that Court reversed the order of the District Court for the District of Columbia and remanded the cause with instructions to dissolve the injunction and to dismiss the Bill of Complaint; and that thereafter in 1939 the petitioner applied to the Supreme Court of the United States for a writ of certiorari to review the judgment of the United
22 States Court of Appeals which petition was denied.

Denies the remaining allegations of fact contained in subparagraph (h) of paragraph 5 of the petition.

5. (i) Admits the allegations contained in subparagraph (i) of paragraph 5 of the petition.

5. (j) Denies the allegations contained in subparagraph (j) of paragraph 5 of the petition.

Denies generally and specifically each and every allegation contained in the petition not hereinbefore admitted, qualified or denied.

Wherefore, respondent prays that the Board redetermine the deficiency herein to be the amount determined by the Commissioner, viz.: $15,176.01.

(Signed) J. P. Wenchel BAT
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
F. R. Shearer,
Division Counsel.

Gerald W. Brook[illegible],
Rollin H. Transue,
Special Attorneys,
Bureau of Internal Revenue.

23 BEFORE THE UNITED STATES BOARD OF TAX APPEALS.

* * (Caption—106518) * *

STATEMENT OF EVIDENCE.

(Filed August 31.)

The above entitled cause came on for hearing at Chicago, Illinois, before the Honorable Richard L. Disney, member of the United States Board of Tax Appeals, on the 4th day of December, A. D. 1941, and Samuel W. Witwer, Jr. appeared on behalf of petitioner, and D. A. Taylor, Esq., appeared on behalf of respondent. Thereupon, the following proceedings were had and the parties by their attorneys submitted the following evidence:

1. The petitioner, S. B. Heininger, was a resident of Chicago, Illinois, at the time of the filing of the petition herein. Petitioner now resides at Athens, Wisconsin. The returns for the periods here involved were filed with the Collector of Internal Revenue for the First District of Illinois, at Chicago, Illinois.

24 2. On December 3, 1940, the respondent mailed to petitioner a notice of deficiency in federal income taxes for the years 1937 and 1938.

3. The taxes in controversy are income taxes for the calendar years 1937 and 1938, and the deficiencies asserted are in the amounts of $10,816.62 and $4,359.39, respectively.

4. During the years from about 1926 to 1939, petitioner was a licensed dentist in the State of Illinois. His principal work since about 1932 was the making of artificial dentures, commonly known as false teeth, for customers living outside of the City of Chicago who did not personally visit petitioner's office.

5. On September 22, 1937 a citation was issued by the Solicitor of the Post Office Department, charging that petitioner was engaged in conducting a scheme for obtaining funds through the mails by means of false and fraudulent practices, in violation of 39 U. S. C. A., Sections 259 and 732. Shortly thereafter petitioner appeared before the United States Post Office Department, answered said charges and employed attorneys to render legal services to petitioner in resisting the issuance of the so-called "Fraud Order" under said Statute. During 1937 peti-

tioner paid attorneys' fees and other legal expenses in
25 connection with said proceedings, amounting to $7,-
069.99; said payments were reasonable in amount.

6. On February 19, 1938, and after hearing under the aforesaid citation, the Postmaster General of the United States issued a so-called "Fraud Order," forbidding the Postmaster at Chicago, Illinois, to pay any money orders drawn to the order of petitioner, and instructing said Postmaster to return all mail addressed to the petitioner to the senders, marked "Fraudulent." Thereafter, on February 25, 1938, petitioner filed suit in the District Court of the United States for the District of Columbia against James A. Farley, Postmaster General, and on that date said Court entered an order directing the Postmaster General to hold all mail addressed to petitioner until the further order of the Court.

7. On June 6, 1938, the District Court of the United States for the District of Columbia granted to petitioner a permanent injunction, restraining the Postmaster General of the United States from enforcing the aforesaid "Fraud Order" or otherwise proceeding in accordance with the terms of said "Fraud Order." Thereafter the Postmaster General appealed said case to the Court of Appeals for the District of Columbia, and on April 17, 1939 that Court reversed the Order of the District Court
for the District of Columbia and remanded the cause
26 with instructions to dissolve the injunction and to dismiss the Bill of Complaint. Thereafter, in the October Term, A. D. 1939, petitioner applied to the Supreme Court of the United States for a Writ of Certiorari to review the judgment of the United States Court of Appeals, which Petition for Certiorari was denied.

8. Pursuant to mandate of the aforesaid Court of Appeals, the said District Court entered an order dissolving the aforesaid injunction and dismissing the aforesaid Bill of Complaint. Said order is now final and in full force and effect.

9. During the year 1938 petitioner paid to attorneys for legal services in prosecuting his injunction suit in the District Court of the United States for the District of Columbia, and defending the aforesaid appeal of the Postmaster General to the Circuit Court of Appeals for the District of Columbia, and in applying to the Supreme Court of the United States for Writ of Certiorari, fees

and legal expenses aggregating $29,530.56; said payments were reasonable in amount.

(The foregoing evidence contained in a Stipulation of Facts, which was entered into by and between the petitioner and respondent and filed herein, is material to this review. Other evidence contained in said stipulation is omitted here as immaterial.)

27 S. B. Heininger, petitioner, testified that he presently resides at Athens, Wisconsin, but that he resided in Chicago at the time of the filing of the petition for redetermination before the Board of Tax Appeals. His business in the years 1937 and 1938 consisted of the manufacture and sale of false teeth by mail. This was his sole business except from February 19, 1938 to July 6, 1938, during which period petitioner was prevented from engaging in business by reason of the Post Office Order.

The evidence shows that petitioner conducted his said business as follows:

On receiving an inquiry by mail from a prospective customer, petitioner mailed to him a portion of wax known as a first impression material, together with an order blank, catalog of prices, and instructions regarding the use of the wax. This wax impression material was then returned to petitioner by mail and examined by petitioner, who thereupon chose a suitable "tray" and the right amount of impression material and returned this "tray" by mail to the customer with instructions for use. The customer then returned the "tray" to petitioner by mail with a second impression of his mouth. Petitioner then examined the "tray" and if it gave a satisfactory impression, proceeded to make the upper plate. If the impression was not satisfactory petitioner mailed additional material to the customer with further instructions in order to

28 obtain a better impression. Upon receiving the impression, the petitioner would examine it again and if it was satisfactory he would then proceed to make a plate, in some cases trying as many as four times to obtain a satisfactory impression. If upon the fourth attempt, the impression on the "tray" was not satisfactory, petitioner discontinued the procedure and mailed to the customer the initial deposit which accompanied the order for the artificial dentures. If the impression was satisfactory, he finished the upper plate and sent it out c. o. d. for the price of the upper plate only, together with a wax "bite" for petitioner's use in preparing the lower plate. Upon re-

ceiving the lower plate "bite", petitioner would commence construction of the lower plate and finish and mail it to the customer c. o. d.

Petitioner rendered no dentistry services in his office during 1937 and 1938, and did not have a dentist's chair there. He manufactured and shipped artificial dentures to customers who sent him orders from all States in the Union, other than Illinois.

Thereupon, counsel for the petitioner offered and there were received in evidence and marked Petitioner's Exhibits 3, 4 and 5, being order blanks used by petitioner during the years 1937 and 1938 on all sales of artificial dentures manufactured and shipped by him during said years.

The petitioner's Exhibits 1 and 2, and respond-
29 ent's Exhibit A are omitted as immaterial and unnecessary for consideration of the questions presented for review.

(The foregoing was all of the evidence offered by petitioner and the respondent in this cause which is material and necessary for consideration of the questions presented for review.)

Thereupon, counsel for petitioner and counsel for respondent stated that they had no further evidence to present and submitted the case to a member of the United States Board of Tax Appeals presiding during the hearing. True copies of petitioner's Exhibits 3, 4 and 5, which were introduced in evidence at the hearing, are attached hereto and made a part of this Statement of Evidence.

Petitioner, S. B. Heininger, tenders and presents the foregoing as his Statement of Evidence in this case, and prays that same may be approved by the United States Board of Tax Appeals and made a part of the record in this cause.

Lloyd L. Lanham,
Samuel W. Witwer, Jr.

Dated: August 28, 1942.

30 PETITIONER'S EXHIBIT 3.

60 Day Trial Blank

Date.....

Dr. S. B. Heininger, D. D. S.
440 W. Huron Street
Chicago, Illinois

Dear Doctor:

1. Enclosed find $..... Please rush plates as soon as possible. 2. Age..... Color of hair..... 3. Color of eyes..... Complexion: dark, medium or light..... 5. How long have teeth been out?..... 6. Have you worn plates before?..... 7. Are you wearing an upper or a lower plate now?..... 8. Have you any natural teeth in your mouth now? If so, are they in the lower or the upper jaw?..... 9. Were your natural teeth small, medium or large in size?.....

Plate Wanted: (Mark with X in square)

| Style No. ..... | Upper ☐ | Lower ☐ | Full Set ☐ |

Be sure to give Style Number

Remarks: .....

.....

Name ..... Street Address .....
Post Office..... State..... R. F. D..... Box.....

Please order your plates according to this trial blank. If you prefer or cannot send the full amount, just send $2.00 as a deposit and I will send plates C. O. D. for the Balance. You take no risk in sending full amount as you can try them for 60 days and I absolutely guarantee satisfaction or refund your money. You are the sole judge. I take your word.

Dr. S. B. Heininger, D. D. S.

31 PETITIONER'S EXHIBIT 4.

Special Offer for 15 Days Only

60 Day Trial Blank

Date.....

Dr. S. B. Heininger, D. D. S.
440 W. Huron Street
Chicago, Illinois

Dear Doctor:

1. Enclosed find $..... Please rush plates as soon as possible. 2. Age..... Color of hair..... 3. Color of eyes..... Complexion: dark, medium or light..... 5. How long have teeth been out?..... 6. Have you worn plates before?..... 7. Are you wearing an upper or a lower plate now?..... 8. Have you any natural teeth in your mouth now? If so, are they in the lower or the upper jaw?..... 9. Were your natural teeth small, medium or large in size?.....

Plate Wanted: (Mark with X in square)

| Style No. ..... | Upper ☐ | Lower ☐ | Full Set ☐ |

Be sure to give Style Number

Remarks: .....

.....

Name ..... Street Address .....

Post Office..... State..... R. F. D..... Box.....

Please order your plates according to this trial blank. If you prefer or cannot send the full amount, just send $2.00 as a deposit and I will send plates C. O. D. for the Balance. You take no risk in sending full amount as you can try them for 60 days and I absolutely guarantee satisfaction or refund your money. You are the sole judge. I take your word.

Dr. S. B. Heininger, D. D. S.

Important

Before mailing this order blank, be sure that you have filled in the Style of Plate wanted—also whether you wish an Upper or Lower Plate or Complete Set.

Pledge Card:

Date.....

Dr. Heininger:

I promise to show my teeth to at least two of my friends. I will tell where I purchased them and how they can go about getting a set like the ones I have.

Signed.....

Your Signature Here Is Important

32 PETITIONER'S EXHIBIT 5.

60 Day Trial Blank

Date.....

S. B. Heininger
440 W. Huron Street, Chicago, Illinois

Dear Sirs:

1. Enclosed find $..... Please rush plates as soon as possible. 2. Age..... Color of hair..... 3. Color of eyes..... 4. Complexion: dark, medium or light..... 5. How long have teeth been out?..... 6. Have you worn plates before?..... 7. Are you wearing an upper or a lower plate now?..... 8. Have you any natural teeth in your mouth now? If so, are they in the lower or the upper jaw?..... 9. Were your natural teeth small, medium or large in size?..... Were your natural teeth protrusive, retrusive or perpendicular?.....

Plate Wanted: (Mark with X in square)

Style No.	Upper ☐	Lower ☐	Full Set ☐

Be sure to give Style Number

Remarks: .....

Name..... Street Address.....

Post Office..... State..... R. F. D..... Box.....

Please order your plates according to this trial blank. Just send $2.00 or more as a deposit and we will send the plates C. O. D. for balance. Please do not send in the full amount as we prefer to send plates C. O. D. for some balance. You take absolutely no risk as you can try these teeth for 60 days with guaranteed satisfaction in every way or your money will be refunded. You are the sole judge. We take your word.

Yours truly,
S. B. Heininger

Filed June 10, 1942. 33 UNITED STATES BOARD OF TAX APPEALS

S. B. Heininger, Petitioner, *vs.* Commissoner of Internal Revenue, Respondent.

Docket No. 106518. Promulgated June 10, 1942.

1. Petitioner, engaged in selling false teeth by mail, received initial deposits from customers under a written promise to refund all moneys in case of dissatisfaction after 60 days' trial. The deposits were placed, with other amounts paid, in petitioner's only bank account. The orders for false teeth had not been filled or completed at the end of the taxable years. *Held*, that the liability to refund was only contingent and that the deposits constituted income.

2. Petitioner expended moneys to resist issuance of a "fraud order" by the Postmaster General, barring his use of the mails, also in obtaining an injunction against the fraud order, resisting appeal therefrom, and unsuccessfully applying to the Supreme Court for certiorari after the Circuit Court had reversed the granting of the injunction. *Held*, such expense was not ordinary and necessary expense of trade or business. *National Outdoor Advertising Bureau* v. *Helvering*, 89 Fed. (2d) 878, followed.

Samuel W. Witwer, Jr., Esq., for the petitioner.

D. A. Taylor, Esq., for the respondent.

OPINION.

DISNEY: The present proceeding involves income taxes for the calendar years 1937 and 1938. The Commissioner determined deficiencies in the respective amounts of $10,816.62 and $4,359.39. The petitioner urges error as to the major portion of the amounts. The questions presented are whether certain amounts received by the petitioner were properly added to gross income, and whether certain attorney fees were deductible as ordinary and necessary expenses of business. The income tax returns involved were filed with the collector for the first district of Illinois at Chicago, Illinois. The greater portion of the facts have been stipulated, as follows:

1. The petitioner, S. B. Heininger, was a resident of Chicago, Illinois, at the time of the filing of the petition herein. Petitioner now resides at Athens, Wisconsin. The returns for the periods here involved were filed with
34 the Collector of Internal Revenue for the First District of Illinois, at Chicago, Illinois.

2. On December 3, 1940, the respondent mailed to petitioner a notice of deficiency in federal income taxes for the years 1937 and 1938, a true and correct copy of which is attached as Exhibit A to the petition herein.

3. The taxes in controversy are income taxes for the calendar years 1937 and 1938, and the deficiencies asserted are in the amounts of $10,816.62 and $4,359.39, respectively.

4. During the years from about 1926 to 1939, the petitioner was a licensed dentist in the State of Illinois. His principal work since about 1932 was the making of artificial dentures, commonly known as false teeth, for customers living outside of the City of Chicago who did not personally visit petitioner's office. Before said dentures were made for a customer, petitioner required from and there was forwarded to him from such customer a payment of $2.00 generally designated by the petitioner and hereinafter for convenience referred to as "deposit". Said dentures, when completed for said nonresident customers, were mailed or shipped to them, C. O. D., for the amount of petitioner's respective charges less the $2.00 "deposit". For various reasons some of the "deposits" were returned to said clients and the dentures ordered by them were not furnished by the petitioner. For years prior to the year 1937, the petitioner consistently followed the practice of

entering said "deposits" in his books of account as gross receipts when received, against which he entered as offsets thereto when returned the amounts of the "deposits" returned, and reflected the difference as gross income in his income tax returns for those years.

5. Petitioner's books of account for the years 1937 and 1938 recorded aforesaid "deposits" and said "deposits" returned and gross income as set forth in paragraph 4, *supra*. On December 31, 1937, the petitioner credited to a "deposit account" an item of $20,593.60 representing "deposits" on orders which had not been filled or completed. Of said amount, $3,656.60 represented "deposits" received during the period prior to January 1, 1937, and $16,937.00 represented "deposits" received during the year 1937. Said item of $20,593.60 was deducted from petitioner's gross income arrived at as set forth, *supra*, in his income tax return filed for the year 1937. On December 31, 1938 the petitioner credited to said "deposit account" an item of $6,900.63 representing "deposits" received during the year 1938. During the year 1938 the petitioner completed, mailed and/or shipped dentures on which deposits in the amount of $13,823.94 had been made in prior years and which were included in the said item of $20,593.60. On December 31, 1938 said "deposit account" was charged with said item of $13,823.94 and gross receipts for 1938 were increased in a like amount, leaving in said "deposit account" as of January 1, 1939 the amount of $13,670.29 ($20,593.60 minus $13,823.94 plus $6,900.63) representing deposits on orders for dentures unfilled as of that date. In petitioner's income tax return for said year 1938 the aforesaid item of $13,823.94 was included in gross income and the said item of $6,900.63 was deducted from gross income.

In the respondent's final determination of the petitioner's tax liability for said year 1937, as evidenced by his notice of deficiency, a copy of which is attached to the petition herein as Exhibit A, the respondent disallowed as a deduction the said item of $3,656.60 and included in gross income the said item of $16,937.00. The petitioner concedes that the respondent's action in disallowing the said deduction of $3,656.60 was proper and in the final determination herein of petitioner's tax liability for the said year, said deduction should be disallowed.

In the respondent's final determination of the deficiency herein for the said year 1938, as evidenced by his notice

of deficiency, a copy of which is attached to the petition
35 herein as Exhibit A, the respondent elminated from gross income the said item of $13,823.94 and included in petitioner's gross income the said item of $6,900.63.

6. Petitioner's income tax returns were at all times filed on the cash receipts and disbursements basis. The petitioner never applied for nor received permission from the Commissioner of Internal Revenue to change his method of accounting or filing his income tax returns employed for years prior to 1937.

7. On September 22, 1937 a citation was issued by the Solicitor of the Post Office Department, charging that petitioner was engaged in conducting a scheme for obtaining funds through the mails by means of false and fraudulent practices, in violation of 39 U. S. C. A., Sections 259 and 732. Shortly thereafter petitioner appeared before the United States Post Office Department, answered said charges and employed attorneys to render legal services to petitioner in resisting the issuance of the so-called "Fraud Order" under said Statute. During 1937 petitioner paid attorneys' fees and other legal expenses in connection with said proceedings, amounting to $7,069.99; said payments were reasonable in amount.

8. On February 19, 1938, and after a hearing under the aforesaid citation, the Postmaster General of the United States issued a so-called "Fraud Order," forbidding the Postmaster at Chicago, Illinois, to pay any money orders drawn to the order of petitioner, and instructing said Postmaster to return all mail addressed to the petitioner, to the senders, marked "Fraudulent". Thereafter, on February 25, 1938, petitioner filed suit in the District Court of the Untied States for the District of Columbia against James A. Farley, Postmaster General, and on that date said Court entered an order directing the Postmaster General to hold all mail addressed to petitioner until the further order of the Court.

9. On June 6, 1938, the District Court of the United States for the District of Columbia granted to petitioner a permanent injunction, restraining the Postmaster General of the United States from enforcing the aforesaid "Fraud Order" or otherwise proceeding in accordance with the terms of said "Fraud Order". Thereafter the Postmaster General appealed said case to the Court of Appeals for the District of Columbia, and on April 17, 1939 that Court reversed the Order of the District Court for the District

of Columbia and remanded the cause with instructions to dissolve the injunction and to dismiss the Bill of Complaint. The opinion of the said Court of Appeals is reported at 105 Fed. 2d 79, of which this Board may take judicial notice. Thereafter, in the October Term, A. D. 1939, petitioner applied to the Supreme Court of the United States for a Writ of Certiorari to review the judgment of the United States Court of Appeals, which Petition for Certiorari was denied.

10. A copy of the Bill of Complaint filed by the petitioner in said District Court including a copy of the aforesaid "Fraud Order" attached thereto as "Exhibit A"; a copy of the Answer thereto; a copy of the Restraint Order entered by the said District Court; a copy of the Court's opinion; and a copy of the Court's order of permanent injunction are set forth in "Exhibit A", as labeled therein, which is attached hereto and made a part hereof.

11. Pursuant to mandate of the aforesaid injunction and dismissing the aforesaid Bill of Complaint. Said order is now final and in full force and effect.

12. During the year 1938 petitioner paid to attorneys for legal services in prosecuting his injunction suit in the District Court of the United States for the District of Columbia, and defending the aforesaid appeal of the Postmaster General to the Circuit Court of Appeals for the District of Columbia, and in applying to the Supreme Court of the United States for Writ of Certiorari, fees and legal expenses aggregating $29,530.56; said payments were reasonable in amount.

36 We find the facts to be as stipulated. In addition, from evidence adduced, we further find:

The petitioner on receiving an inquiry by mail customarily mailed a portion of wax called "first impression" material with an order blank and catalogue of prices and instructions as to how to use the wax. The customer would return it with an impression of the teeth, and was then furnished with material for a second impression. If this was satisfactory, the upper plate was made. If not satisfactory, further material was sent to get a better impression. If upon a fourth effort a satisfactory impression was not secured the procedure was discontinued and the deposit mailed back to the customer. If finally satisfactory, the upper plate was finished and sent c. o. d. for the price of the upper plate only, with wax for an impression

for the lower plate which in like manner was finished and sent c. o. d. The petitioner's gross receipts from the dental business in the year 1937 were $287,582.82 and in 1938 were $150,168.27. Refunds made in 1938 were $27,349 and for the year 1937 were $38,062.08. The petitioner had only one bank account, upon which he drew to pay operating expenses and refunds which were made whenever customers asked for them, whether before or after the completion of the dentures, if the customer was not satisfied. This was pursuant to a written statement included in the order blank used, to the effect that satisfaction was guaranteed or the customer's money would be refunded after a trial of the teeth of 60 days.

1. We first consider the question whether the Commissioner erred in including in petitioner's gross income amounts received by petitioner as deposits upon dental work ordered from him by mail, under a written agreement, embodied in the order blank used by the customer, that his money would be refunded in case of dissatisfaction. The petitioner of course has the burden of showing respondent's action to be error. Petitioner in substance contends that there was, in each of the taxable years, when the deposits were received, no certainty that the contracts would be completed, perhaps particularly in 1938, in September of which year the Post Office citation was issued, that the money had not been earned, and the deposit was earnest money held in suspense; therefore the amounts did not constitute income. The respondent on his part in effect argues that the money had been received without restriction as to disposition or use, and was therefore gross income.

We note at once that one element of the petitioner's argument has no factual basis in the record: though he argues, on brief, that in the taxable year "As yet, he had done no work and performed no services whereby he earned the deposit", the record does not bear out such statement. Indeed, immediately prior to the above quoted language,

37 he had stated that nothing had been done prior to the close of the year "other than to secure either a preliminary or final impression or to commence preparation of the first plate"—which shows on its face that at least some work had been done, something earned. This may well have reasonably been as much as or more than the $2 deposit here involved. The record does not tell us what proportion that amount bore to the fee for the

finished product. Moreover, the evidence, by stipulation, is simply that on December 31, 1937, the deposits credited to the "deposit account" by the petitioner (and which were not returned as gross income by him) were "on orders which had not been filled or completed." Likewise the amounts left in the deposit account on December 31, 1938, were those "representing deposits on orders for dentures unfilled as of that date." An exhibit refers to the deposits on hand at the close of each year as "on orders not completed as yet." This constitutes all the evidence on the point. Obviously this is no showing that the $2 deposits had not been earned during the year, merely because orders had not been "filled" or "completed." The burden being upon the petitioner, we hold that no showing is made that the deposits had not been earned during the respective taxable years. Yet the petitioner seems to recognize this point of fact as decisive, for on reply brief he says:

> The question before this Board is whether petitioner did anything in the respective years of receipt whereby he became entitled to the deposits, as *earnings*. Here the facts operated to place the status of the deposits, *as earnings*, in suspense throughout the respective years of receipt. * * *

Shortly after this appear the statements quoted above to the effect that the deposits had not been earned at the end of the year. We consider it clear that there is no showing that the deposits had not been earned. The only question, then, is the effect of an agreement to return them in case of dissatisfaction. That agreement covered not only the $2 deposits, but the entire amount received, and no claim is made that the petitioner's argument applies to more than the $2 deposits, the balance being returned as income. The argument could, when limited, as we have limited it, to the effect of the written agreement to return in case of dissatisfaction, be applied to petitioner's entire income with equal logic.

The petitioner cites *Webb Press Co., Ltd.*, 3 B. T. A. 247. That case involved a contract for sale of a cotton compress, where title was retained until acceptance, which did not occur until the next year, so that we held the money received in advance to be income in the following year. The case is of little help here, where there is no title retention and no question of acceptance. Here the customer merely has a right to return of his money if dissatisfied. *Bourne* v. *Commissioner*, 62 Fed. (2d) 648, also cited, is a

similar case, where there was advance payment or
38 "earnest money" on a contract to sell real estate, where title did not pass and deed was not delivered until a later year, in which it was held the payment constituted income. We think such cases do not control here, where there is found only agreement to refund, not a retention of title or a contract not accepted. The same in effect is true of *Virginia Iron, Coal & Coke Co.* v. *Commissioner*, 99 Fed. (2d) 919; and *Reginald Denny*, 33 B. T. A. 738, involved a loan, neither paid nor received as income. Here, we think, the $2 was both so paid and received. It was deposited by the petitioner in his only bank account, subject to his check and disposition, and, in our opinion, it was, as we said in *D. H. Byrd*, 32 B. T. A. 568, 572, "subject only to an unliquidated contingent liability." It was received "under a claim of right and without restriction as to its disposition." *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417; *Brown* v. *Helvering*, 291 U. S. 193. The petitioner seeks to distinguish these two cases, cited by the respondent, by the suggestion that there was no earning in the taxable year. We have above noted that there is no such proof in the record. The contract to refund was in effect that this would be done if there was dissatisfaction after a trial of 60 days. Such agreement, in our opinion, does not demonstrate that gross income does not include money received upon the contract. That the petitioner might discontinue business because of the fraud orders does not require a different conclusion. On this point the respondent is not shown to have erred.

2. Was there error in refusing deduction of attorney fees paid in connection with the fraud order issued by the Postmaster General and finally unsuccessful effort to obtain a permanent injunction against it? The respondent cites that line of cases which holds, in sum, that expense for attorney fees is not ordinary and necessary if paid to defend, unsuccessfully, a criminal case, where there is conviction, or expense of paying fines. The petitioner seeks to distinguish the situation herein from that involved in such cases, on the ground that here remedies afforded him by the law were asserted, and that there was no judicial determination of wrongdoing or admission of illegality. Here the Solicitor of the Post Office Department issued a citation for fraud order, under a statute so authorizing if he has evidence satisfactory to him that any person is engaged in conducting any scheme or device for obtaining

money or property through the mails by means of false or fraudulent pretenses, representations, or promises. Petitioner unsuccessfully expended money in 1937 for attorney fees in resisting the citation issued. The Postmaster General in 1938 issued the fraud order, the petitioner secured a permanent injunction in the United States District Court against the order, but upon appeal there was reversal,
39 the Circuit Court of Appeals specifically holding that the sole question before it was whether there was substantial evidence before the Postmaster General warranting the issuance of the fraud order, that his conclusion was presumptively correct, that the judgment of the court could not be substituted for that of the Postmaster General, and that there was substantial evidence before the Postmaster General: therefore the reversal. In 1938 the petitioner expended moneys for attorney fees to secure the injunction, and to defend the appeal and unsuccessfully apply to the Supreme Court of the United States for certiorari. The amounts expended are stipulated to be reasonable. Are they allowable as ordinary and necessary expense of trade or business?

After careful consideration of this somewhat novel question we have come to the conclusion that the petitioner is not entitled to the deduction claimed. *National Outdoor Advertising Bureau* v. *Helvering*, 89 Fed. (2d) 878, in our opinion governs this case. There a bill in equity was filed by the Attorney General of the United States to enjoin certain matters which he thought unlawful. A consent decree in equity issued forbidding the acts, but not finding that they had been committed. The Board of Tax Appeals considered that, since there was no evidence of commission of criminal acts and since the decree had been directed to acts in the future, expenses incurred in defense of the suit should be deducted. Upon appeal the Circuit Court, reversing the Board, said:

> * * * If it is never necessary to violate the law in managing a business, it cannot be necessary to resist a decree in equity forbidding violations, except in cases where an injunction is unjustified. * * *

Herein also we find proceedings not under the criminal statutes, the first, resistance to a "fraud order" citation by the Postmaster General, and the second, an injunction proceeding by the petitioner to enjoin such order after its issuance. Though here there was no consent involved in

the fraud order or the final opinion denying injunction, nevertheless there was a holding by the Postmaster General that the practice complained of existed, and a sustention thereof by the Circuit Court. It is as if in the *National Outdoor Advertising* case there had been a decree of injunction on the merits, without consent. We think that opinion is based upon the fact of decree, and not the consent. The court seems to be of the opinion that if a decree of injunction is justified where there is a contention of unlawful practice, the expense is not deductible as ordinary and necessary expense. That the practices herein complained of by the Postmaster General were unlawful is demonstrated by examination of the Federal statutes: The fraud order was issued under sections 259 and 732 of Title 39, U. S. Code Annotated. The part thereof pertinent here is:

> The Postmaster General may, upon evidence satisfactory to him * * * that any person or company is conducting any other scheme or device for obtaining money or property of any kind through the mails by means of false or fraudulent pretenses, representations, or promises * * * [act to bar the use of the mails or forbid payment of money orders, etc.]

The language is the same in the two statutes. But the same expression is the gist of a *criminal* statute. Section 338 of Title 18, U. S. Code Annotated, provides that:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises * * * shall * * * place * * * any letter * * * in any post office * * * shall be fined not more than $1,000 or imprisoned not more than five years, or both.

In other words, the use of the mails in any scheme for obtaining money or property by means of false or fraudulent pretenses, representations, or promises is ground for barring from the mails, and for criminal prosecution. Though no criminal prosecution is suggested in the proceeding, it is apparent that the ground for the fraud order was the unlawful character charged to the practices of the petitioner. Use of the mails for lawful purposes would be no logical basis for a fraud order. We therefore think that injunction against unlawful practices appears here just as in the *National Outdoor Advertising* case. That case certainly

stands for the principle that a criminal case and conviction therein is not a necessary base for denial of deduction of legal expenses involved, but that a civil proceeding involving injunction against practice forbidden by law, unsuccessfully defended, calls for such denial. The reversal of the Board's view in that case, in our opinion, requires denial of the petitioner's contention here, as is shown by the fact that deduction of expense was allowed by the court in so far as the defense was successful. We cited the *National Outdoor Advertising* case in *Textile Mills Securities Corporation*, 38 B. T. A. 623, 631. The proceeding in which the legal expenses are involved need be only civil, such as injunction. Such proceeding here appearing, we conclude and hold that the respondent did not err in denying the claim of deduction for legal expenses in either year.

Decision will be entered for the respondent.

Entered June 13, 1942.

41 UNITED STATES BOARD OF TAX APPEALS.

(Caption—106518)

DECISION.

Pursuant to the determination of the Board, as set forth in its opinion promulgated June 10, 1942, it is

Ordered and Decided: That there are deficiencies in income tax for the calendar years 1937 and 1938 in the respective amounts of $10,816.62 and $4,359.39.

Entered June 13, 1942.

(Signed) R. L. Disney,

(Seal) *Member.*

42 BEFORE THE UNITED STATES BOARD OF TAX APPEALS. Filed Aug. 13, 1942.

S. B. Heininger,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} B.T.A. No. 106518.

PETITION FOR REVIEW BY THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT AND STATEMENT OF POINTS.

(Filed August 13, 1942.)

To the Honorable, the Judges of the United States Court of Appeals, for the Seventh Circuit:

I.

Jurisdiction.

S. B. Heininger, your petitioner, respectfully petitions this Honorable Court to review the decision of the United States Board of Tax Appeals entered on June 13, 1942, finding deficiencies in income tax due from petitioner for the calendar years 1937 and 1938 in the respective amounts of $10,816.62 and $4,359.39.

Your petitioner, at the time of filing this petition, is a citizen of the United States and resides at Athens, Wisconsin.

43 The returns of income tax, in respect to which the said alleged income tax liability arose, were filed by petitioner with the Collector of Internal Revenue for the First Collection District of Illinois, in the City of Chicago, State of Illinois, which is located within the jurisdiction of the Circuit Court of Appeals for the Seventh Judicial Circuit.

Jurisdiction of this Court to review the decision of the United States Board of Tax Appeals is founded on Section 1141 of the Internal Revenue Code (U. S. C. Title 28, Sec. 346).

II.

Nature of Controversy.

During the years from 1928 to 1939, petitioner was a licensed dentist, maintaining a laboratory and place of business at Chicago, Illinois. His only occupation during the taxable years involved was the making of artificial dentures, commonly called false teeth, for customers living outside of the State of Illinois, who did not personally visit petitioner's office. This business was conducted by mail in the following manner. The petitioner advertised throughout the United States, and upon receiving inquiries by mail petitioner mailed to each prospective customer printed matter descriptive of the artificial dentures manufac-
44 tured by him, a price list, an order form, and a portion of wax called "first impression material," with instructions as to the use of the wax. Generally the customer then returned by mail the wax material on which he had made an oral impression, returning also an executed order blank accompanied by a $2.00 deposit. This order blank designated the type of denture to be manufactured, and provided that when the plate or plates were finished, that the same should be sent C.O.D. for the balance of the purchase price. When satisfactory impressions were obtained petitioner manufactured and sent the plate or plates C.O.D. for the unpaid purchase price. Petitioner rendered no personal dentistry service in his office in Chicago or elsewhere, and accepted no orders originating from places within the State of Illinois. His sole occupation was the sale by mail order methods of artificial dentures to persons residing outside of the State of Illinois.

On September 22, 1937, a citation was issued by the Solicitor of the Post Office Department, charging that petitioner was engaged in conducting a scheme to obtain funds through the mails by means of false and fraudulent practices, in violation of 39 U. S. C. A., Sections 259 and 732. Petitioner thereupon appeared before the Post Office Department, answered said charges and employed attorneys to resist the issuance of a so-called "fraud order" under said statute. During 1937 petitioner paid attorneys'
45 fees and other legal expenses in connection with said proceeding amounting to $7,069.99. It is agreed that these payments were reasonable in amount.

On February 19, 1938, the Postmaster General of the United States issued a so-called "fraud order," forbidding the Postmaster at Chicago, Illinois, to pay any money orders drawn to the order of petitioner, and instructed said Postmaster to return all mail addressed to the petitioner to the sender, marked "Fraudulent." On February 25, 1938, petitioned filed suit in the District Court of the United States for the District of Columbia against James A. Farley, Postmaster General, and on that date said Court entered an order directing the Postmaster General to hold all mail addressed to petitioner until the further order of the Court. From February 19, 1938 until June 6, 1938, petitioner ceased doing business.

On June 6, 1938 the District Court of the United States for the District of Columbia granted petitioner a permanent injunction, restraining the Postmaster General of the United States from enforcing the so-called "fraud order." On or about June 6, 1938, petitioner resumed his business and continued to manufacture and sell false teeth by mail. On April 17, 1939, the Court of Appeals for the District of Columbia, on appeal by the Postmaster General, reversed the order of the District Court and remanded the case
46 with instructions to dissolve the injunction and dismiss the Bill of Complaint. Subsequent to that decision petitioner ceased to manufacture and sell false teeth by mail.

In the October Term, 1939, petitioner applied to the Supreme Court of the United States for a Writ of Certiorari to review the judgment of the United States Court of Appeals, which petition for Certiorari was denied. During 1939 petitioner paid to attorneys for legal services in connection with the injunction suit in the District Court, in defending the aforesaid appeal in the Circuit Court of Appeals for the District of Columbia, and in applying to the Supreme Court of the United States for a Writ of Certiorari, fees and legal expenses aggregating $29,530.56. It is agreed that these payments were reasonable in amount.

Upon rveiewing petitioner's income tax returns for the years 1937 and 1938, the Commissioner of Internal Revenue erroneously disallowed the deductions for attorneys' fees in the respective amounts of $7,069.99 and $29,530.36 paid by petitioner in the years 1937 and 1938. The Board of Tax Appeals held that the said attorneys' fees and legal expenses were not an ordinary and necessary expense of petitioner's trade or business, and sustained the determination of the Commissioner of Internal Revenue.

47

III.

Statement of Points.

In making said decision, the United States Board of Tax Appeals committed the following errors upon which your petitioner relies as the basis of this proceeding:

1. The Board erred in failing to find and conclude that the amounts paid by petitioner in 1937 for attorneys' fees and legal expenses in resisting the issuance of the so-called "fraud order" were ordinary and necessary business expenses within the meaning of Section 23 (a) of the Revenue Act of 1936, as amended, and further erred in failing to sustain the petitioner's right to deduct said payments for attorneys' fees and legal expenses amounting to $7,069.99 from income in his income tax return for the year 1937.

2. The Board erred in failing to find and conclude that the amounts paid by petitioner in 1938 for attorneys' fees and legal expenses in resisting the issuance of the so-called "fraud order" and seeking to have it set aside were ordinary and necessary business expenses within the meaning of Section 23 (a) of the Revenue Act of 1938, as amended, and further erred in failing to sustain the petitioner's right to deduct said payments for attorneys' fees and legal expenses amounting to $29,530.36 from income in his income tax return for the year 1938.

48 3. The Board erroneously gave to the administrative proceedings conducted by the Post Office Department and to the issuance of the so-called "fraud order" the effect of a judicial determination that petitioner was guilty of wrong-doing in the conduct of his mail order business, and erroneously concluded therefrom that petitioner was not entitled to deduct said payments of $7,069.99 and $29,530.36 for attorneys' fees and legal expenses from income in his income tax returns for said years.

4. The Board erred in failing to find and conclude that the Post Office Department proceeding was merely an administrative proceeding which can be given no effect whatever in determining petitioner's right to take the deductions in question. The Board should have found and concluded that the petitioner was entitled to deduct the attorneys' fees and legal expenses paid in 1937 and 1938 in the exercise of legal remedies afforded him by law in resisting the issuance of said so-called fraud order, and in

applying to the courts to restrain the enforcement of that order.

5. The Board erroneously considered itself bound by the authority of the case of *National Outdoor Advertising Bureau* v. *Helvering*, 89 Fed. (2d) 878, the facts of which case are inapplicable to the present proceeding, and the law of which case is in conflict with decisions of Courts of Appeal of other Circuits.

49 6. The Board erred in failing to find and conclude that petitioner's sole business was the manufacture and sale of artificial denfures by mail; and the Board should have found that it was petitioner's only method of doing business, not merely an adjunct of petitioner's business, which the Postmaster General characterized as a scheme or device for obtaining money through the mail by false and fraudulent pretenses. Accordingly, giving the erroneous effect which it did to the so-called "fraud order" consistently the Board should have found and concluded that petitioner's business was illegal in its entirety.

7. The Board erred in failing to find and conclude that even if petitioner's business be viewed for the purpose of this proceeding as illegal in its entirety, petitioner was nevertheless entitled to deduct the aforesaid attorneys' fees and legal expenses paid by him in the years 1937 and 1938 as ordinary and necessary expenses of such business, since under Section 23 (a) of the Revenue Acts of 1936 and 1938 ordinary and necessary expenses of an illegal business are deductible.

8. The Board erred in sustaining the determination of the Commissioner of Internal Revenue whereby the Commissioner disallowed as deductions from income in the years 1937 and 1938 the said payments made by petitioner for attorneys' fees and legal expenses.

50 Wherefore, your petitioner prays that this Honorable Court may review the decision and order of the United States Board of Tax Appeals and reverse and set aside the said order in so far as the same disallows the deduction for attorneys' fees and legal expenses paid by petitioner in the years 1937 and 1938 aforesaid, and further prays that this Honorable Court reverse and set aside said order and direct said Board to enter an order finding and concluding that said deductions were lawful and proper and overruling the determinations of the Commissioner of Internal Revenue proposing income tax de-

ficiencies based upon a disallowance of said deductions; and for the entry of such further orders and directions as shall by this Court be deemed meet and proper in accordance with law.

(Signed) Floyd Lanham,
(Signed) Samuel W. Witwer, Jr.,
Attorneys for Petitioner,
231 South La Salle Street,
Room 1210,
Chicago, Illinois.

State of Illinois, } ss.
County of Cook. }

Samuel W. Witwer, Jr., being first duly sworn, says:

I am one of the attorneys for the petitioner in this proceeding; I prepared the foregoing petition and am
51 familiar with the contents thereof. The allegations of fact contained therein are true to the best of my knowledge, information and belief. This petition is not filed for the purpose of delay and I believe that the petitioner is justly entitled to the relief sought.

(Signed) Samuel W. Witwer, Jr.

Subscribed and sworn to before me this 27th day of August, A. D. 1942.

(Signed) Lolita A. Conway,
(Seal) *Notary Public.*

My commission expires March 19, 1944.

State of Illinois, } ss.
County of Cook. }

Floyd L. Lanham, being first duly sworn, says:
I am one of the attorneys for the petitioner in this proceeding; I assisted in the preparation of the foregoing petition and am familiar with the contents thereof. The allegations of fact contained therein are true to the best of my knowledge, information and belief. This petition is not filed for the purpose of delay and I believe that the petitioner is justly entitled to the relief sought.

(Signed) Floyd Lanham.

Subscribed and sworn to before me this 27th day of August, A. D. 1942.

(Signed) Lolita A. Conway,
(Seal) *Notary Public.*

My commission expires March 19, 1944.

53 In the United States Circuit Court of Appeals

Filed Sept. 3, 1942.

For the Seventh Circuit.

S. B. Heininger,
Petitioner on Review.
vs.
Commissioner of Internal Revenue,
Respondent on Review.
} B. T. A. Docket No. 106518.

NOTICE OF FILING PETITION FOR REVIEW AND STATEMENT OF POINTS.

(Filed Sept. 3, 1942.)

To: J. P. Wenchel, Chief Counsel,
Bureau of Internal Revenue.

You are hereby notified that S. B. Heininger did, on the 31st day of August, 1942, filed with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Seventh Circuit, of the decision of the

Board heretofore rendered in the above entitled case. Copies of the petition for review and the statement of points as filed are hereto attached and served upon you.

Dated this 1st day of Sept. 1942.

B. D. Gamble,
B. D. Gamble,
Clerk U. S. Board of Tax Appeals.

Service of copy of Petition for Review and Statement of Points acknowledged this Sept. 2, 1942.

J. P. Wenchel,
Bureau of Internal Revenue, Attorney for Respondent.

Filed Sept. 28, 1942. 54 UNITED STATES BOARD OF TAX APPEALS.

* * * (Caption—106518) * * *

DESIGNATION OF RECORD TO BE INCLUDED IN THE RECORD ON APPEAL.

(Filed Sept. 28, 1942.)

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, copies duly certified as correct of the following documents and records in the above entitled cause in connection with the Petition for Review by the said Circuit Court of Appeals for the Seventh Circuit, heretofore filed by the above named petitioner:

1. Docket entries of the proceedings before the Board.
2. Petition filed on February 26, 1941 and the document referred to in Paragraph 2 thereof as Notice of Deficiency (a copy of which was attached to said Petition and marked Exhibit A).

55 3. Answer filed April 10, 1941.

4. Findings of Fact and the Opinion of the Board promulgated on June 10, 1942.
5. Order of Re-Determination entered June 13, 1942.
6. Petition for Review filed as of August 31, 1942.
7. Proof of Service of Copy of Petition for Review upon Respondent.

8. Statement of Evidence filed as of August 31, 1942 including Petitioner's Exhibits 3, 4 and 5 attached thereto.
9. Designation for Record.
10. Notice of Filing Designation for Record and the admission of service thereof.

said transcript to be prepared as required by law and the rules of the United States Circuit Court of Appeals for the Seventh Circuit.

Floyd L. Lanham,
Samuel W. Witwer, Jr.,
Attorneys for Petitioner.

56 UNITED STATES BOARD OF TAX APPEALS. Filed Oct. 5, 1942.

* * (Caption—106518) * *

NOTICE OF FILING OF DESIGNATION OF RECORD TO BE INCLUDED IN THE RECORD ON APPEAL.

(Filed Oct. 5, 1942.)

To: J. P. Wenchel,
Chief Counsel,
Bureau of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

Please take notice that on the 26th day of September, A. D. 1942, the undersigned attorneys for S. B. Heininger, petitioner in the above entitled proceedings, have filed with the Clerk of the United States Board of Tax Appeals, a Designation of Record to be included in the Record on Appeal, a copy of which is annexed hereto.

Floyd L. Lanham,
Samuel W. Witwer, Jr.

Dated: September 26, 1942.

Receipt of the foregoing Notice of Filing of Designation of Record and service of a copy of the Designation of Record herein mentioned, is acknowledged this 23rd day of September, A. D. 1942.

J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

57 UNITED STATES BOARD OF TAX APPEALS.

* * (Caption—106518) * *

CERTIFICATE.

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 55, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 5th day of October, 1942.

(Seal)

B. D. Gamble,
Clerk, United States Board of Tax Appeals.

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 8130

October Term, 1942, January Session, 1943

S. B. HEININGER, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for Review of Decision of the United States Board of Tax Appeals

February 15, 1943.

Before SPARKS, MAJOR, and MINTON, Circuit Judges

MINTON, Circuit Judge. The petitioner, S. B. Heininger, seeks to review a judgment of the United States Board of Tax Appeals which found the petitioner liable for deficiencies in income taxes for the years 1937 and 1938.

The petitioner, a dentist, conducted a mail order business in which he undertook to make false teeth and supply them by mail. The Post Office Department instituted a fraud order proceeding against the petitioner, which resulted in a finding that his methods were fraudulent, and an order against him denying to him the use of the mails. If he could not use the mails, he was out of business. Consequently, he filed suit in the District Court for the District of Columbia against the Postmaster General, and obtained a permanent injunction against him from enforcing the fraud order. On appeal to the Circuit Court of Appeals for the District of Columbia, the judgment of the District Court was reversed, and the fraud order of the Post Office Department was sustained.

In the defense of his business in the proceedings in the Post Office Department and the District Court and the Circuit Court of Appeals, the petitioner incurred and paid several thousand dollars for attorneys' fees and expenses. It is admitted that the expenses were reasonable. By these legal proceedings, the enforcement of the fraud order was enjoined and remained enjoined until the reversal by the Circuit Court of Appeals.

During this time, in the years 1937 and 1938, the petitioner continued in business and returned a gross income for 1937 of $287,582.82, and for 1938 of $150,168.27. While his litigation was ultimately unsuccessful, it did allow him to keep his business going

in 1937 and 1938, and enabled him to earn the large income indicated above.

The petitioner sought to deduct from his gross income for 1937 and that for 1938, as an ordinary and necessary expense of carrying on that business, the attorneys' fees and expenses of the litigation. The Commissioner disallowed the deduction, and the Board of Tax Appeals affirmed. The question is: Are such expenses deductible as ordinary and necessary expenses in carrying on that business, within the meaning of Section 23 (a) (1), 26 U. S. C. A., 49 Stat. 1648?[1]

What is an ordinary expense is discussed by Mr. Justice Cardozo in Welch v. Helvering, 290 U. S. 111, 114, 54 S. Ct. 8, 78 L. Ed. 212:

"Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack."

By this standard, we think it plain that the expense in the instant case was ordinary. It was such an expense as related strictly to the life of the business.

Not only must the expense be ordinary; it must also be necessary. In Kornhauser v. United States, 276 U. S. 145, 153, 48 S. Ct. 219, 72 L. Ed. 505, Mr. Justice Sutherland, in discussing the allowance, as a deduction, of attorneys' fees as a business expense, said:

"* * * Where a suit or action against a taxpayer is directly connected with, or, as otherwise stated, * * * proximately resulted from, his business, the expense incurred is a business expense within the meaning * * * of the act."[2]

We think that where an expense is incurred which saves the life of a business, even for a time, it is, in the light of the above interpretation, not only a business expense, but a necessary business expense. Without the expenditure, there would have been no income in this case because there would have been no business. The Business depended directly upon the expense incurred in the litigation. We therefore hold that the expense was both ordinary and necessary.

---

[1] "Section 23. Deductions from gross income.—In computing net income there shall be allowed as deductions:
"(a) Expenses.
"(1) In general.
"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *"

[2] The provisions of the Act referred to are identical with those of Sec. 23 (a) (1) under consideration.

Our conclusion is supported by the case of Foss v. Commissioner, 75 F. (2d) 326, 1st Circuit, and Gravel Company v. Commissioner, 95 F. (2d) 615, 616, 5th Circuit. In the Foss case, Foss was the owner of stock in the American Blower Company and the B. F. Sturtevant Company. He was sued by the minority stockholders of the American Blower Company, and charged with entering a combination to divert the business of that company to the B. F. Sturtevant Company, and to violate the Sherman Act. The District Court sustained the charges, and granted relief. The Circuit Court of Appeals modified the relief granted, but otherwise sustained the District Court. Foss incurred large attorneys' fees, which he sought to deduct from his income as ordinary and necessary expenses of his business. This deduction was disallowed by the Board of Tax Appeals, but on appeal to the Circuit Court of Appeals, the deduction was allowed, the court relying upon Kornhauser v. United States, supra.

In the Gravel Company case, the Board of Tax Appeals had refused to allow the company to deduct, as an ordinary and necessary expense of its business of selling gravel, commissions paid to one Dore on sales to the State Highway Commission. The disallowance was because of the fact that Dore was a State Senator. There was no evidence that he was to use or did use his political influence to obtain contracts with the Highway Commission, as all of the contracts were let by competitive bidding. The Circuit Court of Appeals reversed the Board of Tax Appeals, and said:

"The revenue laws of the United States are not over-squeamish. By the broad definition of gross income, income arising from an illegal business is taxed even though the illegality be one declared by the Constitution itself. United States v. Sullivan, 274 U. S. 259, 47 S. Ct. 607, 71 L. Ed. 1037, 51 A. L. R. 1020. The provisions of the statute fixing the deductions to be regarded in arriving at the net income which alone is taxed, 26 U. S. C. A. Sec. 23, are as broad and unqualified as those defining the taxable gross income. Ordinary and necessary expenses of an illegal business would therefore seem to be deductible if they would have been had the business not been prohibited."

The Board of Tax Appeals based its decision in the instant case upon National Outdoor Advertising Bureau v. Helvering, 89 F. (2d) 878. In that case, the taxpayer was charged with a violation of the Sherman Act. As to part of the charges, the taxpayer defended successfully. As to the balance, it agreed to a consent decree. The taxpayer sought to deduct attorneys' fees incurred and paid in this litigation. The Circuit Court of Appeals approved a deduction as to the attorneys' fees and expenses incurred and paid in successfully defending certain of the charges,

but denied the right to deduct for legal expenses incurred and paid in negotiating the settlement and drafting the consent decree. The court held in effect that an expense cannot be necessary if incurred in the defense of an unlawful business. We are not inclined to follow this case.

The Government also relies strongly upon Textile Mills Corp. v. Commissioner, 314 U. S. 326, 62 S. Ct. 272, 86 L. Ed. 242, where a corporation sought to deduct certain lobbying expenses. Such expenses were clearly prohibited as a deduction by the Treasury Regulations which provided, "Sums of money expended for lobbying purposes * * * are * * * not deductible from gross income." The Supreme Court held that this was a proper regulation for the purpose of carrying out the provisions of the statute.

For many years, the Bureau of Internal Revenue has taxed the income of illegal business in the same manner as the income of legal business. United States v. Sullivan, 274 U. S. 259, 47 S. Ct. 607, 71 L. Ed. 1037. Although this provision was known to Congress, it still made no change in the law so as to subject the income of illegal business to a treatment different from that of legal business. Both, so far as the statutes and the regulations of the Department went, were to be taxed on their net income. If the position of the respondent is sustained, and the attorneys' fees and expenses disallowed as a deduction in the instant case, then no business expense of an illegal business is deductible, and such business would be taxable on its gross income. Congress has not said that that discrimination shall be made. Neither has the Department had the hardihood to make such a material change by way of its regulations. If this change is to be made and the policy altered, let Congress do it. Congress would need only to add the word "legal" before the word "trade" in the third line of Section 23 (a) (1).

We are asked, in the guise of construing the words "ordinary and necessary," to amend the statute. In other words, to engage in a little judicial legislation. We decline the invitation.

If the deduction in the case at bar was not an ordinary and necessary expense to the "carrying on" of the business, we are unable to understand the English language. Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary.

The judgment of the Board of Tax Appeals is reversed.

And on the same day, to wit: On the fifteenth day of February 1943, the following further proceedings were had and entered of record, to wit:

Monday, February 15, 1943

Court met pursuant to adjournment

Before Hon. WILLIAM M. SPARKS, Circuit Judge; Hon. J. EARL MAJOR, Circuit Judge; Hon. SHERMAN MINTON, Circuit Judge.

No. 8130

S. B. HEININGER, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for Review of Decision of the United States Board of Tax Appeals

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof: It is ordered and adjudged by this Court that the Decision of the United States Board of Tax Appeals entered in this cause on June 13, 1942, be, and the same is hereby, reversed, and that this cause be, and the same is hereby, remanded to the United States Board of Tax Appeals.

United States Circuit Court of Appeals for the Seventh Circuit

I, Kenneth J. Carrick, Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, do Hereby certify that the foregoing typewritten pages contain a true copy of the Opinion of the Court, filed on the fifteenth day of February 1943, and the Judgment entered on the same date, in Cause No. 8130, S. B. Heininger, Petitioner vs. Commissioner of Internal Revenue, Respondent, as the same remains upon the files and records of the United States Circuit Court of Appeals for the Seventh Circuit.

In testimony whereof I hereunto subscribe my name and affix the seal of said United States Circuit Court of Appeals for the Seventh Circuit, at the City of Chicago, this 29th day of April A. D. 1943.

[SEAL]

KENNETH J. CARRICK,
Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.

U. S. GOVERNMENT PRINTING OFFICE: 1943

Supreme Court of the United States

Order allowing certiorari

(Filed June 14, 1943)

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

INDEX

CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

S. B. HEININGER

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit entered in the above entitled cause on February 15, 1943, and reversing the decision of the Board of Tax Appeals.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 25–34) is reported in 47 B. T. A. 95. The opinion of the circuit court of appeals (R. 46–50) is reported in 133 F. (2d) 567.

JURISDICTION

The judgment of the circuit court of appeals was entered on February 15, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer, who was engaged in the business of making and supplying artificial dentures by mail order, can deduct as ordinary and necessary business expenses under Section 23 (a) of the Revenue Acts of 1936 and 1938 the sums spent by him in unsuccessfully resisting the issuance and enforcement of a fraud order by the Postmaster General relating to such business.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Apppendix, *infra*, pp. 8–10.

STATEMENT

The pertinent facts, as stipulated by the parties and as found by the Board, are as follows (R. 25–29):

The taxpayer was a licensed dentist in Illinois during the years 1926 to 1939. His principal work since 1932 was the making of artificial dentures for customers who did not personally visit his office. Before such dentures were made for a customer, the taxpayer required from and there

was forwarded to him from such customer a payment of $2 generally designated as a "deposit". The dentures, when completed, were mailed or shipped, C. O. D., for the amount of the charges less the $2 "deposit". (R. 25.) The gross receipts from this business, in 1937, were $287,582.82, and for 1938 they amounted to $150,168.27 (R. 29).

On September 22, 1937, a citation was issued by the Solicitor of the Post Office Department, charging that the taxpayer was engaged in conducting a scheme for obtaining funds through the mails by means of false and fraudulent practices, in violation of Section 3929 of the Revised Statutes (Appendix, *infra*). Shortly thereafter the taxpayer appeared before the Post Office Department, answered these charges, and employed attorneys to render legal services in resisting the issuance of a statutory "Fraud Order". (R. 27.)

On February 19, 1938, and after a hearing under the above-mentioned citation, the Postmaster General issued a "Fraud Order," forbidding the Postmaster, at Chicago, Illinois, to pay any money orders drawn to the order of the taxpayer, and instructing the Postmaster to return all mail addressed to the taxpayer, to the senders, marked "Fraudulent". Thereafter, on February 25, 1938, the taxpayer filed suit in the District Court for the District of Columbia against James A. Farley, Postmaster General, and on that date the court

entered an order directing the latter to hold all mail addressed to the taxpayer until the further order of the court. (R. 27.)

On June 6, 1938, the district court granted the taxpayer a permanent injunction, restraining the Postmaster General from enforcing the "Fraud Order" or otherwise proceeding in accordance with its terms. On appeal, the order of the district court was reversed and the case was remanded with instructions to dissolve the injunction and to dismiss the bill of complaint. The taxpayer's application for a writ of certiorari was denied in the October Term, 1939.[1] The taxpayer paid attorneys' fees and other legal expenses in connection with the above-mentioned proceedings amounting to $7,069.99 in 1937, and to $29,530.56 in 1938. (R. 27–28.)

The Commissioner refused to allow the taxpayer to take deductions for these sums, and the Board of Tax Appeals approved the Commissioner's determination on the ground that such expenditures did not constitute ordinary and necessary expenses of the taxpayer's business but were incurred in connection with illegal practice (R. 27, 31–34). The circuit court of appeals reversed the decision of the Board of Tax Appeals (R. 46–50).

[1] That case is reported as *Farley* v. *Heininger*, 105 F. (2d) 79 (App. D. C.), certiorari denied, 308 U. S. 587.

SPECIFICATION OF ERRORS TO BE URGED

The circuit court of appeals erred:

1. In holding that expenses incurred in unsuccessfully resisting the issuance of a fraud order by the Postmaster General should be treated as ordinary and necessary business expenses and may be deducted from gross income.

2. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

The decision of the Seventh Circuit in this case is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *National Outdoor Advertising Bureau* v. *Helvering,* 89 F. (2d) 878, in which it was held that the taxpayer could not deduct as a necessary business expense the sum spent in negotiating a consent decree in a suit in equity brought by the United States under the anti-trust laws.

The decision of the court below is also basically in conflict with *Helvering* v. *Superior Wines and Liquors, Inc.* (C. C. A. 8), decided March 22, 1943 (1943 C. C. H., Par. 9354), which denied a deduction for the sum paid as a compromise of a liquor law violation and also the sum paid for the attorneys' fees in connection with the settlement.

The above decisions of the Second and Eighth Circuits are consistent with and are supported by numerous cases. They accordingly indicate the

policy which has been followed by courts in similar circumstances. See *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, upholding regulations interpreting ordinary and necessary business expenses as not including lobbying expense to procure legislation; *United States* v. *Jaffray*, 97 F. (2d) 488 (C. C. A. 8),[2] denying the deduction of a sum paid as a penalty for a negligent understatement of taxes; *Great Northern Ry. Co.* v. *Commissioner*, 40 F. (2d) 372 (C. C. A. 8), certiorari denied, 282 U. S. 855, denying a deduction of a penalty paid for violation of a statute pertaining to railroads; *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 F. (2d) 178 (C. C. A. 2), denying the deduction of counsel fees as well as fines paid in the prosecution of violators of a price-fixing statute; *McDuffie* v. *United States*, 19 F. Supp. 239 (C. Cls.), denying deduction of sums spent in unsuccessfully defending a suit brought by the United States for cancellation of a lease on grounds of fraud; and *Maddas* v. *Commissioner*, 40 B. T. A. 572, affirmed, 114 F. (2d) 548 (C. C. A. 3), refusing to allow deduction of sums paid for protection in running an illegal business. In earlier cases the Seventh Circuit itself took a view in accord with these decisions. See *Tinkoff* v. *Commissioner*, 120 F. (2d) 564, and *Standard Oil Co.* v. *Commissioner*, 129 F. (2d) 363, certiorari

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[2] Affirmed on other issues *sub nom. United States* v. *Bertlesen & Petersen Co.*, 306 U. S. 276.

denied, 317 U. S. 688. Consequently, its decision in the instant case is contrary to a well established current of decision and produces uncertainty as to whether expenditures in connection with illegal activities may be deducted as "ordinary and necessary" expenses. The problem is recurrent and warrants consideration by this Court in view of the conflict.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

MAY 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

Revenue Act of 1938, c. 289, 52 Stat. 447:

Section 23 (a) is identical with Section 23 (a) of the Revenue Act of 1936, *supra*.

Revised Statutes:

> SEC. 3929. The Postmaster General may, upon evidence satisfactory to him that any person or company is engaged in conducting any lottery, ~~gift enterprise~~, or scheme for the distribution of money, or of any real or personal property by lot, chance, or drawing of any kind, or that any person or company is conducting any other scheme

> or device for obtaining money or property of any kind through the mails by means of false or fraudulent pretenses, representations, or promises, instruct postmasters at any post office at which registered letters or any other letters or mail matter arrive directed to any such person or company, or to the agent or representative of any such person * * * to return all such mail matter to the postmaster at the office at which it was originally mailed, with the word "Fraudulent" plainly written or stamped upon the outside thereof; and all such mail matter so returned to such postmasters shall be by them returned to the writers thereof, under such regulations as the Postmaster General may prescribe. Nothing contained in this section shall be so construed as to authorize any postmaster or other person to open any letter not addressed to himself. * * * (39 U. S. C., sec. 259.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> ART. 23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * * Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 23 (a)–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, acci-

dent, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provisions of section 23, see section 24.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

Article 23 (a)–1 is identical with Article 23 (a)–1 of Treasury Regulations 94, *supra*.

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CITATIONS

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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 63

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

S. B. HEININGER

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 25–34) is reported in 47 B. T. A. 95. The opinion of the Circuit Court of Appeals (R. 46–49) is reported in 133 F. (2d) 567.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 15, 1943 (R. 50). The petition for a writ of certiorari was filed on May 14, 1943, and was granted on June 14, 1943. The

jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer, who was engaged in the business of making and supplying artificial dentures by mail order, can deduct as ordinary and necessary business expenses under Section 23 (a) of the Revenue Acts of 1936 and 1938 the sums spent by him in unsuccessfully resisting the issuance and enforcement of a fraud order by the Postmaster General relating to such business.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 22–24.

STATEMENT

The pertinent facts, as stipulated by the parties and as found by the Board, are as follows (R. 25–29):

The taxpayer was a licensed dentist in Illinois during the years 1926 to 1939. His principal work since 1932 was the making of artificial dentures for customers who did not personally visit his office. Before such dentures were made for a customer, the taxpayer required from and there was forwarded to him from such customer a payment of $2 generally designated as a "deposit." The dentures, when completed, were mailed or shipped, C. O. D., for the amount of the charges

less the $2 "deposit". (R. 25.) The gross receipts from this business, in 1937, were $287,582.82, and for 1938 they amounted to $150,168.27 (R. 29).

On September 22, 1937, a citation was issued by the Solicitor of the Post Office Department, charging that the taxpayer was engaged in conducting a scheme for obtaining funds through the mails by means of false and fraudulent practices, in violation of Section 3929 of the Revised Statutes. Shortly thereafter the taxpayer appeared before the Post Office Department, answered these charges, and employed attorneys to render legal services in resisting the issuance of a statutory "Fraud Order". (R. 27.)

On February 19, 1938, and after a hearing under the above-mentioned citation, the Postmaster General issued a "Fraud Order," forbidding the Postmaster at Chicago, Illinois, to pay any money orders drawn to the order of the taxpayer, and instructing the Postmaster to return all mail addressed to the taxpayer, to the senders, marked "Fraudulent." Thereafter, on February 25, 1938, the taxpayer filed suit in the District Court for the District of Columbia against James A. Farley, Postmaster General, and on that date the court entered an order directing the latter to hold all mail addressed to the taxpayer until the further order of the court. (R. 27.)

On June 6, 1938, the District Court granted the taxpayer a permanent injunction, restraining the Postmaster General from enforcing the

"Fraud Order" or otherwise proceeding in accordance with its terms. On appeal, the order of the District Court was reversed on April 17, 1939, and the case was remanded with instructions to dissolve the injunction and to dismiss the bill of complaint. The taxpayer's application for a writ of certiorari was denied in the October Term, 1939.[1] The taxpayer paid attorneys' fees and other legal expenses in connection with the above-mentioned proceedings amounting to $7,069.99 in 1937, and to $29,530.56 in 1938. (R. 27–28.)

The Commissioner refused to allow the taxpayer to take deductions for these sums, and the Board of Tax Appeals approved the Commissioner's determination on the ground that such expenditures did not constitute ordinary and necessary expenses of the taxpayer's business but were incurred in connection with illegal practices (R. 27, 31–34). The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals (R. 46–50).

SUMMARY OF ARGUMENT

The legal expenses incurred by the taxpayer in unsuccessfully resisting the issuance and enforcement of a statutory fraud order by the Postmaster General are not deductible as "ordinary and necessary" expenses. Not only are deductions from

[1] That case is reported as *Farley* v. *Heininger*, 105 F. (2d) 79 (App. D. C.), certiorari denied, 308 U. S. 587.

gross income a matter of legislative grace to which the taxpayer must clearly establish his right, but the taxpayer also has the burden of overcoming the Commissioner's determination that the expenditures involved were not "ordinary and necessary" expenses.

This Court has construed the statute as embodying an objective test of what is "ordinary and necessary," requiring that expenses in order to be so described result from transactions "of common or frequent occurrence in the type of business involved." *Deputy* v. *du Pont,* 308 U. S. 488, 495; *Welch* v. *Helvering,* 290 U. S. 111, 114. The court below erroneously applied a subjective test, and interested itself only in whether these expenditures were "ordinary and necessary" in this particular taxpayer's scheme of things. The legal expenses in question were incurred as the direct result of taxpayer's participating in activities expressly prohibited by a federal statute. Activities of such nature cannot be said to be "of common and frequent occurrence" in the type of business in which the taxpayer was engaged; certainly in the practice of dentistry it is neither common nor frequent to make false and fraudulent representations through the use of the mails.

Decisions in numerous analogous cases, including *Textile Mills Corp.* v. *Commissioner,* 314 U. S. 326, support the view that implicit in the statute is the understanding that expenditures which, as

here, arise as the result of unlawful transactions or activities which are against public policy, are not deductible as "ordinary and necessary" expenses.

ARGUMENT

THE LEGAL EXPENSES INCURRED BY TAXPAYER IN UNSUCCESSFULLY RESISTING THE ISSUANCE AND ENFORCEMENT OF A STATUTORY FRAUD ORDER BY THE POSTMASTER GENERAL ARE NOT DEDUCTIBLE AS ORDINARY AND NECESSARY BUSINESS EXPENSES

1. In connection with his unsuccessful resistance of the issuance and enforcement of a statutory "Fraud Order" by the Postmaster General, the taxpayer incurred and paid various attorneys' fees and legal expenses which he seeks to deduct from gross income as "ordinary and necessary" business expenses under Section 23 (a) of the Revenue Acts of 1936 and 1938 (Appendix, *infra*, p. 22). At the very outset it should be borne in mind that, since deductions from gross income are a matter of legislative grace, the taxpayer has the burden of establishing his right to the deduction. *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *White* v. *United States*, 305 U. S. 281, 292. And it is firmly settled that deductions or exemptions must be construed strictly against one claiming the benefit thereof. As stated in *Bank of Commerce* v. *Tennessee*, 161 U. S. 134, 146:

> There must be no doubt or ambiguity in the language used upon which the claim to

> the exemption is founded. It has been said that a well founded doubt is fatal to the claim; * * *

See, also, *United States* v. *Stewart*, 311 U. S. 60, 71. Furthermore, since the Commissioner here has ruled that the expenditures in question are not deductible, his ruling has the support of a presumption of correctness, and the taxpayer has the burden of proving it to be wrong (*Welch* v. *Helvering*, 290 U. S. 111, 115).

2. The question presented in the instant case can perhaps be most profitably explored against the background of this Court's decisions in *Welch* v. *Helvering*, *supra*, and *Deputy* v. *du Pont*, 308 U. S. 488, which consider in detail the principles to be applied in determining what constitutes an "ordinary and necessary" business expense.

In the *Welch* case the taxpayer had been an officer in a corporation which had been adjudged an involuntary bankrupt and relieved of its debts. Thereafter the taxpayer began to transact business on his own account and, in order to re-establish relations with customers whom he had known when acting for the corporation, undertook voluntarily to pay the corporate debts. The Commissioner of Internal Revenue ruled that such payments were not deductible from taxable income as ordinary and necessary expenses. This Court assumed that the expenses were "necessary," but sustained the Commissioner on the ground that they were

not "ordinary." Mr. Justice Cardozo said (pp. 114–115):

> Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, * * *. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

In *Deputy* v. *du Pont, supra,* the taxpayer, a large shareholder in the du Pont Company, made sales of his stock to the executive committee of the corporation in furtherance of the company's policy that the committee-men should have a financial interest in the corporation. The taxpayer borrowed the stock so sold and, in accordance with his agreement made with the lender, paid the latter a sum equivalent to the dividends on the borrowed stock, as well as taxes imposed upon the lender. In refusing to characterize such expenditures as "ordinary and necessary" business expenses this Court declared (p. 495):

> Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happen but once in the taxpayer's lifetime. Cf. *Kornhauser*

> v. *United States, supra. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. Welch* v. *Helvering, supra,* 114. * * * [Italics supplied.]

It is apparent, therefore: *first,* that in considering whether a particular payment may be deducted as an "ordinary and necessary" business expense, the nature of that payment is to be determined by the character of the original transaction from which it stemmed; and *second,* that the test to be applied is objective, not subjective, and the expense is deductible only if the transaction from which it resulted is "of common or frequent occurrence in the type of business involved" (*Deputy* v. *du Pont, supra*). Thus, since it is the "origin and nature, and not the legal form, of the expense sought to be deducted, [which] determines the applicability of the words of § 23 (a)" (*Interstate Transit Lines* v. *Commissioner,* decided by this Court June 14, 1943, No. 552, last term) the mere fact that it may be ordinary and customary to defend law suits by employing counsel is not sufficient to permit deduction of legal expenses if the original activities out of which the suit in question arose are not "of common or frequent occurrence in the type of business involved." *Deputy* v. *du Pont, supra.* The application of the principle enunciated by this Court in *Deputy* v. *du Pont, supra,* as it pertains to the deductibility of legal expenses has been well stated

by the Circuit Court of Appeals for the Tenth Circuit in the recent case of *Hales-Mullaly* v. *Commissioner,* 131 F. (2d) 509, as follows (p. 511):

> Ordinarily an expenditure made for attorneys fees or other expenses in the defense of a suit or action against a taxpayer which is directly connected with or proximately resulted from his trade or business is deductible under section 23 (a). *Kornhauser* v. *United States,* 276 U. S. 145, 48 S. Ct. 219, 72 L. Ed. 505. But the naked fact that a voluntary expenditure was made for attorneys fees or other expenses in the course of legal proceedings or as the result of a compromise is not controlling within itself. The decisive test still is the character of the transaction which gives rise to the payment. *Colony Coal & Coke Corp.* v. *Commissioner of Int. Rev.,* 4 Cir., 52 F. 2d 923. It is whether the transaction occasioning the expenditure is normal, usual, or customary in the trade or business of the type in which the taxpayer is engaged. *Deputy* v. *du Pont, supra.*

It does not appear that the court below concerned itself with the principles above outlined. In holding the legal fees in question deductible on the ground that preservation of the taxpayer's business required such expenditures, the court seems completely to have ignored both the nature of the activities engaged in by taxpayer, which gave rise to the outlay, and the basic question

whether those activities were "ordinary and necessary." It erroneously applied a subjective test, whereas the proper test is objective. Here the expenses were incurred by the taxpayer as the direct result of his engaging in a scheme for obtaining money through the mails by means of false or fraudulent representations. The Postmaster General so found, and the Court of Appeals for the District of Columbia judicially determined that finding was fairly arrived at and was supported by substantial evidence. *Farley* v. *Heininger,* 105 F. (2d) 79 (App. D. C.), certiorari denied, 308 U. S. 587. Only through an excess of cynicism can it be said that an expense arising from fraudulent dealings was "ordinary"; that is, that the transaction which gave rise to it was "of common or frequent occurrence in the type of business" in which taxpayer was engaged. Certainly in the practice of dentistry it is not "ordinary" to make false and fraudulent representations through the use of the mails or otherwise. It is even more certain that such conduct is not "necessary." Cf. *Burroughs Bldg. Material Co.* v. *Commissioner,* 47 F. (2d) 178 (C. C. A. 2); *National Outdoor Advertising Bureau* v. *Helvering,* 89 F. (2d) 878 (C. C. A. 2); see also *Great Northern Ry. Co.* v. *Commissioner,* 40 F. (2d) 372 (C. C. A. 8), certiorari denied, 282 U. S. 855; *Tunnel R. R.* v. *Commissioner,* 61 F. (2d) 166 (C. C. A. 8), certiorari denied, 288 U. S. 604. The

court below thought that the expense was "necessary" because it preserved the life of the fraudulently operated business for a time, but the point is that the expense was not necessary unless it was necessary that the fraudulent practices be continued, and as Judge L. Hand has stated in a similar case, "the law will not recognize the necessity of engaging in illegal courses in the conduct of a business." *National Outdoor Advertising Bureau* v. *Helvering, supra*, at p. 881.

3. The correctness of the Government's position here is supported by a number of decisions denying the deduction of expenditures incurred as the result of activities which were illegal or contrary to public policy. These decisions, while not necessarily conclusive, are helpful in showing that such expenditures cannot be regarded as "ordinary and necessary" within the meaning of Section 23 (a).

Thus, it has been uniformly held that fines or penalties paid by the taxpayer as a consequence of statutory violations or legal expenses incurred in an unsuccessful defense of prosecution for such violations, are not deductible even though proximately connected with the taxpayer's business.[2]

[2] Where the legal proceedings fail to establish that the taxpayer has engaged in the illegal activities with which he was charged, it has been held that expenditures incurred in connection with those proceedings may be deducted. *Commissioner* v. *Continental Screen Co.*, 58 F. (2d) 625 (C. C. A. 6); *Commissioner* v. *People's-Pittsburgh Trust Co.*, 60 F. (2d) 187 (C. C. A. 3); *Citron-Byer Co.* v. *Commissioner*, 21 B. T. A. 308; *Headley* v. *Commissioner*, 37 B. T. A. 738;

Burroughs Bldg. Material Co. v. *Commissioner*, 47 F. (2d) 178 (C. C. A. 2) (fines and counsel fees incurred as the result of violation of state price-fixing laws); *Great Northern Ry. Co.* v. *Commissioner, supra*, and *Tunnel R. R.* v. *Commissioner, supra* (penalties paid as the result of violation of federal statute and regulations in operation of railroad). Cf. *Gould Paper Co.* v. *Commissioner*, 72 F. (2d) 698, 702 (C. C. A. 2) (counsel fees paid as result of negotiating a consent decree in a suit in equity and a plea of *nolo contendere* in a criminal prosecution by the United States under the

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G. C. M. 19976, 1938–1 Cum. Bull. 120; cf. *Pantages Theatre Co.* v. *Welch*, 71 F. (2d) 68 (C. C. A. 9).

In the court below the taxpayer built an argument on these cases, in conjunction with the principle of annual accounting (*Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359), to the effect that because the District Court decision enjoining the fraud order was still in effect at the close of the 1938 taxable year, the expenditures were at that time not against public policy and hence were deductible. This argument was not adopted by the court below. Its two major errors are: (1) the tax status of items in litigation is ordinarily determined by the final outcome of the litigation, not by its intermediate stages (see, for example, *United States* v. *Safety Car Heating Co.*, 297 U. S. 88); and (2) if the deduction were allowed in 1938 because the erroneous District Court decision was then in effect, an amount equivalent to the deduction would have to be added back to income in 1939 when the District Court decision was reversed (cf. *Lamont* v. *Commissioner*, 120 F. (2d) 996 (C. C. A. 8)), resulting in a patent distortion of income, which the Commissioner is empowered by section 41 (26 U. S. C. 41) to prevent in order to obtain a clear reflection of income (cf. *Brown* v. *Helvering*, 291 U. S. 193, 203; *Lucas* v. *American Code Co.*, 280 U. S. 445, 449).

anti-trust laws); *National Outdoor Advertising Bureau* v. *Helvering, supra* (legal fees spent in negotiating a consent decree to a suit in equity brought by the United States under the anti-trust laws); *United States* v. *Jaffray*, 97 F. (2d) 488 (C. C. A. 8), affirmed on other issues *sub nom. United States* v. *Bertelsen & Petersen Co.*, 306 U. S. 276 (penalty paid in civil action for negligent understatement of taxes); *Helvering* v. *Superior Wines and Liquors*, 134 F. (2d) 373 (C. C. A. 8) (legal fees and amounts paid in compromise of liabilities for violation of federal taxing statutes); *McDuffie* v. *United States*, 85 C. Cls. 212, 227 (legal fees spent in unsuccessfully defending a suit brought by the United States for cancellation of a lease on the grounds of fraud). See, also, *Bonnie Bros., Inc.* v. *Commissioner*, 15 B. T. A. 1231; *Levinstein* v. *Commissioner*, 19 B. T. A. 99; *Columbus Bread Co.* v. *Commissioner*, 4 B. T. A. 1126; *Achelis* v. *Commissioner*, 28 B. T. A. 244; *Sanitary Earthenware Specialty Co.* v. *Commissioner*, 19 B. T. A. 641; *Atlantic Terra Cotta Co.* v. *Commissioner*, 13 B. T. A. 1289; *Wolf Manufacturing Co.* v. *Commissioner*, 10 B. T. A. 1161; *Thompson* v. *Commissioner*, 21 B. T. A. 568, appeal dismissed, 62 F. (2d) 1082 (C. C. A. 8); *Lindheim* v. *Commissioner*, 2 B. T. A. 229.[3]

[3] In earlier cases, the Circuit Court of Appeals for the Seventh Circuit itself took a view in accord with these decisions. See *Standard Oil Co.* v. *Commissioner*, 129 F. (2d) 363 (C. C. A. 7), certiorari denied, 317 U. S. 688, rehearing

Similarly, considerations of public policy have been dominant in denying deductions on account of bribes paid by bootleggers, or expenses incurred in an illegal gambling enterprise, or payments made in response to commercial extortion (such as payments to racketeers). See *Maddas* v. *Commissioner*, 40 B. T. A. 572, affirmed, 114 F. (2d) 548 (C. C. A. 3); *Silberman* v. *Commissioner*, 44 B. T. A. 600; *Kelley-Dempsey & Co.* v. *Commissioner*, 31 B. T. A. 351; cf. *United States* v. *Sullivan*, 274 U. S. 259, 264. And deductions for "commissions" paid to persons for their use of personal influence in obtaining public contracts have likewise been denied. *Rugel* v. *Commissioner*, 127 F. (2d) 393 (C. C. A. 8); *Easton Trac-*

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denied June 7, 1943, in which it was held that the taxpayer could not deduct as an ordinary and necessary business expense sums paid the United States in compromise of a claim for the conversion of oil taken from the Teapot Dome. And in *Tinkoff* v. *Commissioner*, 120 F. (2d) 564 (C. C. A. 7), the court, relying upon *Welch* v. *Helvering*, *supra*, and *Deputy* v. *du Pont*, *supra*, held that an expenditure incurred by an attorney in an effort to expunge an order of suspension from practice before the Treasury Department "was not an ordinary expense" (p. 566). See also *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7), certiorari denied, 284 U. S. 618, denying the deductibility of penalities paid as a result of the violation of the Safety Appliance Act.

The English courts have reached similar results in applying the cognate provisions of the British Income Tax Acts. See *Inland Revenue Commissioners* v. *Von Glehn*, [1920] 2 K. B. 553; *Inland Revenue Commissioners* v. *Warnes & Co.*, [1919] 2 K. B. 444; *Ward & Co.* v. *Commissioners*, [1923] A. C. 145.

tor & Equipment Co. v. *Commissioner*, 35 B. T. A. 189; *New Orleans Tractor Co.* v. *Commissioner*, 35 B. T. A. 218; *Nicholson* v. *Commissioner*, 38 B. T. A. 190.[4] Likewise, this Court has recently refused to sanction the deductibility, as an ordinary and necessary business expense, of lobbying expenditures to procure legislation. *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326.

The court below refused to follow the *Textile Mills* case apparently on the ground that that decision turned solely upon the existence of a Treasury Regulation which provided that "Sums of money expended for lobbying purposes * * * are not deductible from gross income," and that to deny the deductibility of the expenditures involved in the instant case as ordinary and necessary business expenses, would require the court "to amend the statute." The court did not express

[4] The two cases on which the court below relied for its contrary decision did not go so far as the court evidently thought. *Foss* v. *Commissioner*, 75 F. (2d) 326 (C. C. A. 1), did not involve expenditures in a suit resisting public disciplinary action, and there is no evidence in the opinion that the court gave attention to and rejected the considerations advanced herein. *Alexandria Gravel Co.* v. *Commissioner*, 95 F. (2d) 615 (C. C. A. 5), did not involve expenditures which could be regarded as against public policy since the court held that there was no evidence that they were made to purchase political influence. The court did, however, utter the dictum on which the court below relied. See objections to that dictum in the concurring opinion of Judge Clark in *Textile Mills S. Corp.* v. *Commissioner*, 117 F. (2d) 62, 72 (C. C. A. 3), aff'd 314 U. S. 326.

the view, as indeed it could not reasonably have done, that a greater degree of proximate cause linking the activities and the expenditures existed in this case than in the *Textile Mills* case. The court erred in viewing the Textile Mills regulation as the exclusive application of the considerations of public policy on which it rested. The regulation was illustrative only, and in the nature of things it could not be more since the Commissioner cannot, any more than Congress could, hope to promulgate a regulation to fit precisely each of the circumstances of life encountered by the tax laws. These same considerations of public policy also underlie the provision in Art. 23 (a)–1 of the Regulations (Appendix, *infra*, pp. 23–24) disallowing deduction of penalty payments with respect to Federal taxes. Clearly the Commissioner's recognition of public policy is not confined to those instances where he has issued a general regulation precisely in point. Cf. *Gray* v. *Powell*, 314 U. S. 402, 412; *Gregory* v. *Helvering*, 293 U. S. 465; *Helvering* v. *Clifford*, 309 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473. Thus the *Textile Mills* decision necessarily recognizes that considerations of public policy are properly taken into account in construing the statute herein involved, and it seems hardly open to debate that not only the administrator but the courts as well are expected to apply a construction to the statute which is consistent with public policy. While the statute

makes no express reference to considerations of public policy, "like all language it has to be interpreted in the light of the tacit assumptions upon which it is reasonable to suppose that the language was used" (Mr. Justice Holmes in *Popovici* v. *Agler*, 280 U. S. 379, 383). It has been uniformly interpreted by the courts and the administrator, as the previously cited decisions show (see also G. C. M. 23438, 1942–2 Cum. Bull. 188; O. D. 952, 4 Cum. Bull. 209 (1921); S. R. 3137, IV–1 Cum. Bull. 170 (1925); G. C. M. 11358, XII–1 Cum. Bull. 29 (1933); S. R. 1448, IV–1 Cum. Bull. 140 (1925); I. T. 1174, I–1 Cum. Bull. 269 (1922)), as not intending, for reasons of public policy found to be implicit in its language, to authorize deductions for expenditures occasioned solely by the taxpayer's illegal conduct. This long-standing construction is entitled to great weight, particularly so in view of the successive reenactment by Congress of the statute employing the phrase "ordinary and necessary." Cf. *Brewster* v. *Gage*, 280 U. S. 327; *Textile Mills Corp.* v. *Commissioner*, *supra*; see also *Morgan* v. *Commissioner*, 309 U. S. 78, 81; *Helvering* v. *Winmill*, 305 U. S. 79, 83.

Therefore, while this Court in *Textile Mills Corp.* v. *Commissioner*, *supra*, declared that the rule-making authority might employ the general policy against lobbying activities in its segregation of non-deductible expenses, the fact that in the in-

stant case, unlike the *Textile Mills* case, there is no regulation can not be controlling. Policy considerations such as were present in the *Textile Mills* case are even more clearly present here. Unlike the *Textile Mills* case, we have here an Act of Congress expressly condemning the very activities engaged in by the taxpayer and out of which the expenditures in question grew, and an authoritative determination by the competent authorities that the taxpayer's activities were in violation of that Act. The purpose of the federal statute under which the fraud order against taxpayer was issued and enforced is to prevent the use of the mails as a medium for disseminating printed matter which, on grounds of public policy, has been declared to be non-mailable. *Farley* v. *Heininger,* 105 F. (2d) 79, 84 (App. D. C.), certiorari denied, 308 U. S. 587. The taxpayer, by engaging in those activities condemned by the statute, deliberately violated the established policy of the Government for the protection of the public, and the expenditures involved were incurred in an effort to be allowed to continue the unlawful practices. Clearly such expenditures are not deductible.

The court below interpreted the Government's position as meaning that illegal businesses would be taxable on their gross income. However, the Government's position herein is no more susceptible to this interpretation than the decision of this Court in *Textile Mills Corp.* v. *Commissioner,*

supra, in which lobbying expenses of a lobbying corporation were held nondeductible. Neither the *Textile Mills* case nor the Government's position herein would prevent the respective taxpayers from deducting expenses such as office rent, cost of dental materials, and the like. The vice in the expenses here sought to be deducted as ordinary and necessary is that they were incurred in an unsuccessful attempt to avoid the lawful curb which the Government was seeking to place on unlawful features of the taxpayer's business conduct. To allow the deduction would be to allow compensation for the costs which law enforcement has caused the one who has transgressed, which plainly Congress did not intend. Cf. *Clarke* v. *Haberle Brewing Co.,* 280 U. S. 384.

In any event, the Commissioner has not taken the extreme position which the court below has attributed to him, and this case does not require him to do so. Here the business was not unlawful, though some of the practices were. But the lawful business could be separated from the unlawful practices. Hence this case does not compel consideration of the treatment to be accorded expenses of a business which itself is illegal and, as this Court has often said (*United States* v. *Sullivan,* 274 U. S. 259; *Old Colony Tr. Co.* v. *Commissioner,* 279 U. S. 716, 731), it will be time enough to consider how far the Government's theory may reach when an attempt is made to extend it beyond the situation here presented. Taxation is a prac-

tical matter and there is no occasion to push the argument to "a drily logical extreme." Cf. *I. C. C.* v. *New York, N. H. & H. R. Co.*, 287 U. S. 178, 192.

We know of no instance heretofore where expenditures incurred as the result of unsuccessfully resisting disciplinary measures instituted by the sovereign have been permitted by the courts to be deducted as ordinary and necessary business expenses.[5] We think it clear that the "way of life" envisaged by Congress in enacting Section 23 (a) contemplates no encouragement through that section of those activities which, as in the instant case, constitute public offenses.

CONCLUSION

The decision of the Circuit Court of Appeals is incorrect and should be reversed.

Respectfully submitted.

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SEPTEMBER, 1943.

[5] As pointed out in footnote 4, *supra*, p. 16, the two cases relied on below do not so hold and did not involve the point.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> * * * * *

Section 23 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, is identical with Section 23 (a) of the Revenue Act of 1936, *supra*.

Revised Statutes:

> SEC. 3929, as amended.—The Postmaster General may, upon evidence satisfactory to him that any person or company is engaged in conducting any lottery, gift enterprise, or scheme for the distribution of money, or of any real or personal property by lot, chance, or drawing of any kind, or that any person

or company is conducting any other scheme or device for obtaining money or property of any kind through the mails by means of false or fraudulent pretenses, representations, or promises, instruct postmasters at any post office at which registered letters or any other letters or mail matter arrive directed to any such person or company, or to the agent or representative of any such person or company, whether such agent or representative is acting as an individual or as a firm, bank, corporation, or association of any kind, to return all such mail matter to the postmaster at the office at which it was originally mailed, with the word "Fraudulent" plainly written or stamped upon the outside thereof; and all such mail matter so returned to such postmasters shall be by them returned to the writers thereof, under such regulations as the Postmaster General may prescribe. Nothing contained in this section shall be so construed as to authorize any postmaster or other person to open any letter not addressed to himself. The public advertisement by such person or company so conducting such lottery, gift enterprise, scheme, or device, that remittances for the same may be made by mail to any other person, firm, bank, corporation, or association named therein shall be held to be prima facie evidence of the existence of said agency by all the parties named therein; but the Postmaster General shall not be precluded from ascertaining the existence of such agency in any other legal way satisfactory to himself. (U. S. C., title 39, Sec. 259.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * *. Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 23 (a)–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

Article 23 (a)–1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, is identical with Article 23 (a)–1 of Treasury Regulations 94, *supra*.

U. S. GOVERNMENT PRINTING OFFICE: 1940

FILE COPY

IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1942

No. 1027

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

S. B. HEININGER,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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GUY T. HELVERING, Commissioner of Internal Revenue,

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Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The petitioner has made a sufficient statement of the case.

Reasons for Denial of the Writ.

1. The decision herein of the Seventh Circuit Court of Appeals is manifestly correct and sound.

2. The cases relied upon by the petitioner are clearly distinguishable from the instant case and are not in conflict therewith.

3. The decision below is sustained by the controlling decisions of this Court (*Kornhauser* v. *United States*, 276 U. S. 145-153, 48 S. Ct. 219, and *Welch* v. *Helvering*, 290 U. S. 111, 114, 54 S. Ct. 8, 9); and the decision is supported by *Foss* v. *Commissioner*, 75 F. (2d) 326, (First Circuit), and *Alexander Gravel Co.* v. *Commissioner*, 95 Fed. (2d) 615, 616 (Sixth Circuit).

ARGUMENT.

This petition for a Writ of Certiorari involves the single question whether expenses incurred for attorneys' fees expended in legal proceedings which threaten the life of a business and which, for a time, saved the life of that business and, therefore, made possible the production of taxable income, are deductible as ordinary and necessary business expense within the meaning of Section 23 (a) (1), 26 U. S. C. A., Int. Rev. Code, 49 Stat. 1648.

In the defense of his business the taxpayer incurred and paid attorneys' fees and expenses beginning in about September 1937 (R. 17) in resisting the issuance of a so-called "Fraud Order". These expenditures made it possible for the petitioner to produce the income which was earned by him during the remainder of that year. Thereafter, upon the issuance of such "Fraud Order" in February, 1938, the taxpayer employed attorneys and filed a bill of complaint for injunction in the District Court for the District of Columbia to restrain the execution of the aforesaid "Fraud Order" (R. 18). In June 1938 the taxpayer was granted a permanent injunction against the Postmaster General restraining the execution of the "Fraud Order" (R. 18). The respondent would have had no business income in the year 1938 had he not made the expenditures in question. The Postmaster General appealed from this injunction decree and in April 1939 the United States Court of Appeals reversed the decree of the District Court and ordered the injunction dissolved. Subsequent thereto this Court denied a petition for a Writ of Certiorari (R. 18).

The question now is, are the attorney's fees and legal expenses, so incurred "ordinary" and "necessary" and therefore deductible as business expense. In *Welch* v. *Helvering*, 290 U. S. 111, a taxpayer sought to deduct as business expense payments made by him on the debts of a corporation of which he was a former officer. The payments were made after the corporation's discharge in bankruptcy and for the purpose of strengthening the taxpayer's business standing. In considering whether such payments were "ordinary" in the statutory sense, this Court at page 114 said:

> "Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. *Cf. Kornhauser* v. *United States*, 276 U. S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type."

In the case of *Kornhauser* v. *United States*, 276 U. S. 145, a taxpayer sued to recover an additional income tax payment made by reason of the refusal of the Commissioner of Internal Revenue to allow a deduction from his gross income of a payment of attorney's fees. The fees had been incurred in the defense of an accounting suit instituted by his former co-partner. This Court held that

the payment of attorneys' fees was an ordinary and necessary business expense and at page 153 said:

> "The basis of these holdings seems to be that where a suit or action against a taxpayer is directly connected with, or, as otherwise stated (*Appeal of Backer*, 1 B.T.A. 214, 216), proximately resulted from, his business, the expense incurred is a business expense within the meaning of Sec. 214 (a), subd. (1), of the act. These rulings seem to us to be sound and the principle upon which they rest covers the present case. If the expense had been incurred in an action to recover a fee from a client who refused to pay it, the character of the expenditure as a business expense would not be doubted. In the application of the act we are unable to perceive any real distinction between an expenditure for attorney's fees made to secure payment of the earnings of the business and a like expenditure to retain such earnings after their receipt. One is as directly connected with the business as the other."

That the decision of the Circuit Court of Appeals herein is manifestly sound and correct is apparent when examined in the light of the controlling authorities above cited. The life of the taxpayer's business was threatened; in these circumstances he pursued the "ordinary" and normal course of conduct and proceeded to a "defense against attack". Certainly expenses so incurred were likewise "necessary" because they were "directly connected with" and "proximately resulted from," his business. As stated by the Court of Appeals in its decision (R. 49):

> "Without this expense, there would have been no business. Without the business there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary."

Cases Cited by Petitioner Distinguished.

The case of *National Outdoor Advertising Bureau* v. *Helvering*, 89 Fed. (2) 878, as well as the other authorities relied upon by the petitioner plainly show that the deductions claimed were disallowed because the taxpayer had been adjudicated guilty of illegal conduct or had admitted guilt by consent decree or otherwise. None of these factors were involved in the legal proceedings which were the subject of the attorneys' fees claimed as deductions in the instant case. The respondent proceeded to defend his business against attack, in the commonly recognized manner by the employment of attorneys and sought and obtained relief in the Courts.

Other cases cited by petitioner likewise concern deductions of a wholly different character than those involved in the instant case. As in *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 Fed. (2) 178, where the taxpayer and its president had pleaded guilty and was fined and the attempted deductions included both the fines and the legal expense; *Helvering* v. *Superior Wines and Liquors, Inc.*, 134 Fed. (2) 373, where the deduction claimed had been paid as a compromise of a violation of a statute regulating the traffic in intoxicating liquors and attorneys' fees in connection therewith; *Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326, where the expenses sought to be deducted included "lobbying" expenses which were clearly prohibited by the Treasury Regulations; *United States* v. *Jaffray*, 97 Fed. (2) 488, which concerned negligence penalties imposed under the income tax laws; *Great Northern Ry. Co.* v. *Commissioner*, 40 Fed. (2) 372, which denied the deduction of a sum paid for fines arising from a statutory violation. *McDuffie* v. *United States*, 19 Fed. Supp. 239 (C. Cls.), and *Standard Oil Co.* v. *Commissioner*,

129 Fed. (2) 363, involved deductions of sums paid upon judgments and expenses for a fraud committed against the government. *Maddas* v. *Commission*, 114 Fed. (2) 548, concerns bribes paid to prohibition agents.

CONCLUSION.

The reasons assigned in the opinion of the Circuit Court of Appeals (R. 46-49) are sound and well supported by the decisions of this Court and of other Circuit Courts of Appeal (br. p. 2). We urge that the Petition for a Writ of Certiorari be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1943

No. 63

GUY T. HELVERING, Commissioner of Internal Revenue,

Petitioner,

vs.

S. B. HEININGER,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR RESPONDENT.

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Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR RESPONDENT.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 25-34) is reported in 47 B. T. A. 95. The opinion of the Circuit Court of Appeals (R. 46-49) is reported in 133 F. (2d) 567.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on February 15, 1943 (R. 50). The petition for a writ of certiorari was filed on May 14, 1943, and was granted on June 14, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

Whether the respondent (taxpayer) whose sole business was the manufacture and sale of artificial dentures by mail, can deduct as ordinary and necessary business expenses under Section 23 (a) of the Revenue Acts of 1936 and 1938 the sums expended by him for attorneys' fees and legal expenses in resisting the issuance of a statutory "Fraud Order" by the Postmaster General; and in filing suit for and obtaining a permanent injunction against the execution of such "fraud order" which permanent injunction upon appeal was dissolved, but which expenditure made it possible for respondent (taxpayer) to continue in business and produce a substantial portion of the income which is the subject of the asserted deficiencies.

Statutes and Regulations Involved.

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 19-21.

Statement.

The statement of the case by petitioner omits the pertinent facts that during the years in question, 1937 and 1938, the respondent's *sole business* was the manufacture and sale of false teeth by mail (R. 19); respondent rendered no dentistry service in his office during 1937 and

1938, and did not have a dentist's chair there; he manufactured and shipped artificial dentures to customers who sent his orders from all States in the Union, other than Illinois (R. 20).

Summary of Argument.

The legal expenses paid by the respondent in 1937 and 1938 were "ordinary" and "necessary" business expenses and were therefore deductible from respondent's gross income for those years.

These legal expenses were "ordinary" because they constituted attorneys' fees and legal expense in connection with litigation which threatened the safety of respondent's business and which were, therefore, directly connected with, and proximately resulted from, respondent's business.

These legal expenses were "necessary" because the litigation in which the expense was incurred was proximately related to respondent's business and because these expenditures were the means of saving the life of respondent's business during the years in question, thereby making possible the production of a substantial amount of respondent's income which is the subject of the asserted deficiency.

The decision of the Circuit Court of Appeals herein is sound and correct irrespective of whether respondent's business was a lawful or an unlawful business. If the business was unlawful, it was unlawful in its entirety and had no separable phases, or activities. In either case, whether the business was lawful or unlawful, these legal expenses are deductible because the clearly expressed purpose of the income tax law is to tax *net income*, irrespective of source.

ARGUMENT.

The legal expenses paid by respondent in 1937 and 1938 were ordinary and necessary business expenses and were deductible from respondent's gross income for those years.

During the years in question (1937 and 1938) the sole business of the respondent was the manufacture and sale of false teeth by mail (R. 19). Respondent rendered no dentistry services in his office and did not have a dentist's chair there (R. 20); he was completely dependent upon the use of the mails in the operation of the business. The orders for artificial dentures came to respondent by mail. By the same means, he forwarded to his customers instructions and materials for the taking of impressions of the gums; the impressions were returned to him by mail (R. 19). The artificial dentures were manufactured in respondent's laboratory, from the impressions so taken, and when completed were forwarded to the customer by mail (R. 19). At every step the use of the mails was necessary to the existence of respondent's business.

In these circumstances, with the continued existence of respondent's business wholly dependent upon the use of the mails (R. 19, 20) respondent was served, on September 22, 1937, by the Post Office Department with a citation charging that respondent was conducting a scheme for obtaining money through the mails by means of false or fraudulent pretenses, representations or promises in violation of 39 U. S. C. A., Sections 259 and 732 (R. 17). Because respondent's business was wholly dependent upon

the use of the mails this action threatened the continued existence of the business. Accordingly, respondent retained legal counsel to appear at the Post Office Department hearing and defend against these charges (R. 17).

Thereafter, on February 19, 1938, the Postmaster General issued a "fraud order" instructing the Postmaster at Chicago, Illinois, to return to the senders, marked "Fraudulent," all mail addressed to the respondent and forbidding the payment of any money orders drawn to the order of respondent (R. 18).

It is fair to assume that had the respondent not employed counsel to defend against these charges in the Post Office Department, a "fraud order" would have been issued against him by default and the execution of such order would have terminated respondent's business soon after September 22, 1937. Moreover, had respondent not employed counsel to defend against these charges he would have had no sufficient record of the proceedings to exercise his lawful right to appeal to the Courts for relief against any wrongful or arbitrary action by the Postmaster General. It is indisputable that respondent's expenditures for attorneys' fees and legal expenses in the year 1937, alone, made possible the production of a substantial portion of the income of the business for that year.

The "fraud order" of February 19, 1938 completely extinguished respondent's business because his sole business was the manufacture and sale of artificial dentures by mail (R. 19). Deprived of the use of the mails, respondent had no means of receiving orders for his product; no means of sending impression material and instructions to his customers or of receiving the impressions from which he could manufacture the artificial dentures; and no

means to forward the completed product to the customer or of receiving payment therefor (R. 19).

On February 25, 1938 respondent, through his attorneys, filed a bill of complaint for injunction in the District Court of the United States for the District of Columbia to restrain the execution of the aforesaid "fraud order"; on the same date the District Court entered a restraining order directing the Postmaster General to hold all mail addressed to respondent until the further order of the Court (R. 18). Thereafter on June 6, 1938 the District Court entered a permanent injunction against the Postmaster General enjoining the execution of the aforesaid "fraud order" (R. 18). Respondent thereafter continued in business until about April 17, 1939 when the United States Court of Appeals for the District of Columbia reversed the decree of the District Court and remanded the cause with instructions to dissolve the injunction and dismiss the bill of complaint (R. 18).

It was solely as a result of the attorneys' fees and expenses incurred for the legal services above set forth that the respondent was allowed to continue in business and produce taxable income after the issuance of the "fraud order" on February 19, 1938.

In this state of the record in this case the petitioner asserts that the deduction of these attorneys' fees and legal expenses should be disallowed because such expenditures were not ordinary and necessary expenses for carrying on the business of the respondent. To sustain this position petitioner at page 5 of his brief says "certainly in the practice of dentistry it is neither common nor frequent to make false and fraudulent representations through the use of the mails." But the record shows that the *sole*

business of the respondent was the manufacture and sale of false teeth by mail (R. 19). The fact that respondent was a licensed dentist is of no relation to any issue in this case. Respondent rendered no dentistry service in his office and had no dentist's chair there (R. 20); his customers did not personally visit his office (R. 17). So far as his business was concerned respondent was a mechanic manufacturing an artificial device (dentures) for use as a substitute for natural teeth. The record is clear that respondent was not engaged in the practice of dentistry (R. 17, 19, 20).

Respondent's right to take the deductions in question arises under Section 23 (a) of the Revenue Acts of 1936 and 1938, as amended (Appendix pp. 19-20).

It is well established by the authorities that payments made by a taxpayer in resisting legal proceedings affecting the safety of his business, are deductible as expenses of carrying on the business.

The fact that the respondent was never before required to defend a proceeding in the Post Office Department, or to apply to the courts for injunctive relief against the action of the Postmaster General did not make his expenditures, in so doing, other than "ordinary" business expense.

In *Welch* v. *Helvering*, 290 U. S. 111, a taxpayer sought to deduct as business expense certain payments made by him on the debts of a corporation, of which he was a former officer. The payments were made after the corporation's discharge in bankruptcy, for the purpose of aiding his own business standing. In considering whether such payments were "ordinary" in the statutory sense, this Court said at page 114:

> "Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack."

The right of a taxpayer to deduct payments for attorneys' fees and legal expenses was upheld by this court in the case of *Kornhauser* v. *United States*, 276 U. S. 145. In that case the taxpayer had incured and paid attorneys' fees in the successful defense of an accounting suit instituted by his former co-partner. This Honorable Court held that the payment of attorneys' fees was an ordinary and necessary business expense and at page 152 said:

> "A suit ordinarily, and, as a general thing at least, necessarily requires the employment of counsel and the payment of his charges."

and at page 153:

> "* * Where a suit or action against a taxpayer is directly connected with, or, * * * proximately resulted from, his business, the expense incurred is a business expense within the meaning * * * of the act."[3]

In the case of *Foss* v. *Commissioner*, 75 Fed. (2d) 326, Foss, being the owner of stock in American Blower Company and the Sturtevant Company, was sued by the minority stockholders of the Blower Company and charged with diverting the business of that company to the Sturtevant Company and also with violating the Sherman Act. The District Court sustained the charges and granted re-

(3) The provisions of the act referred to are identical with those of Sec. 23(a) (1) under consideration.

lief. The Circuit Court of Appeals modified the relief granted, but otherwise sustained the District Court. Foss incurred attorneys' fees in this litigation, which he sought to deduct from his income as ordinary and necessary expenses of his business. This deduction was disallowed by the Board of Tax Appeals, but on appeal to the Circuit Court of Appeals, the deduction was allowed and the Court at page 328 said:

> "We entertain no doubt that the counsel fees in question were an ordinary and necessary expense of that business. The test is stated in *Kornhauser* v. *United States*, 276 U. S. 145, 153, 48 S. Ct. 219, 220, 72 L. Ed. 505, in which it was said, 'Where a suit or action against a taxpayer is directly connected with, or, as otherwise stated, * * * proximately, resulted from, his business, the expense incurred is a business expense,' etc. Sutherland, J. The litigation was plainly an outgrowth of the business activities in which Foss was engaged. He was brought into the suit, not as the Government contends, simply because of his stock ownership in the Blower Company, but because of his stock ownership and business activity in the Sturtevant Company and the Blower Company. *It was his business activities in those connections which exposed him to the suit. Under such circumstances counsel fees are a deductible expense, as was expressly held in the Kornhauser case.* See, too, *Commissioner* v. *Continental Screen*, 58 F. (2d) 625 (C. C. A. 6); *Commissioner* v. *People's Pittsburgh Trust Co.* (C. C. A.) 60 F. (2d) 187." (Italics supplied.)

Because the clear purpose of the Revenue Act is to reach only the net portion of a taxpayer's income, those sections of the statute relating to deductions should be, and have been, construed as broadly as those defining gross income. In *Alexandria Gravel Co.* v. *Commissioner*, 95 Fed. (2d) 615, 616, the Circuit Court of Appeals said (p. 616):

"The revenue laws of the United States are not over-squeamish. By the broad definition of gross income, income arising from an illegal business is taxed even though the illegality be one declared by the Constitution itself. *United States* v. *Sullivan*, 274 U. S. 259. *The provisions of the Statute fixing the deductions to be regarded in arriving at the net income which alone is taxed*, 26 U. S. C. A. Sec. 23, *are as broad and unqualified as those defining the taxable gross income. Ordinary and necessary expenses of an illegal business would therefore seem to be deductible if they would have been had the business not been prohibited.*" (Italics supplied.)

In *United States* v. *Sullivan*, 274 U. S. 259-263, the obligation of a taxpayer to pay a tax on the net income from an occupation prohibited by the 18th Amendment to the Constitution, was sustained and this court said, page 263:

"We see no reason to doubt the interpretation of the act, or any reason why the fact that a business is unlawful should exempt it from paying the taxes that if lawful it would have to pay."

There is nothing in the Revenue Act which suggests that expenses of an unlawful business are to be treated any differently than expenses of a lawful business. The sole objective of the income tax laws is to tax net income, irrespective of source.

That the legal expenses here sought to be deducted were ordinary and necessary expense to the "carrying on" of respondent's business is succinctly stated in the opinion below by Mr. Justice Minton, where it is said:

"Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have

been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary." (R. 49).

The "Fraud Order" entered by the Postmaster General does not amount to an adjudication that respondent's business was unlawful.

The Postmaster General is empowered by Section 3929 Revised Statutes (39 U. S. C. Sec. 259) to act pursuant to this statute "upon evidence satisfactory to him." (Appendix p. 19). The Courts have consistently held that any appeal from the action of the Postmaster General under this statute is limited to the sole question of whether there is *any* substantial evidence to sustain the Postmaster General; and that unless the action of the Postmaster General is "palpably wrong and therefore arbitrary" the courts are powerless to intervene. *Leach* v. *Carlisle*, 258 U. S. 138-140; *Farley* v. *Heininger*, 105 Fed. (2d) 79-81. The Postmaster General conducts hearings under this statute as an administrative officer and is not required to apply the rules of evidence as in a Court. *Farley* v. *Simmons*, 99 Fed. (2d) 343-346.

The order of the Postmaster General operates only for the limited purpose of withdrawing the statutory franchise to the use of the Postal facilities. For these reasons we submit that the order of the Postmaster General does not rise to the dignity of the adjudication of a Court; that it cannot be given any collateral effect here, as an adjudication that respondent's business was unlawful. To give such effect to the order of the Postmaster General and to disallow respondent's deductions for that reason would be to deprive the respondent of property without due process of law.

We respectfully submit that the petitioner is not authorized to judge for himself the lawfulness of a taxpayer's conduct. This is a function of the Courts. No Court has ever determined respondent's business to be unlawful. If petitioner be permitted so to sit in judgment then deductions become a matter of grace at his hands.

Resume of Authorities Cited by Petitioner.

We respectfully submit that the authorities put forward by the petitioner do not meet the question here presented. In the main they deal with legal situations involving lawful businesses engaging in unlawful activities and where either upon pleas of *nolo contendre*, guilty or by *consent* decree there has been an adjudication of unlawful activities, as an adjunct, to a lawful business. Whereas, in the instant case, the activities which brought the respondent's business before the Postmaster General were no mere adjunct of respondent's business, they were the business *itself*. Wherefore, we submit that respondent's expenditures for attorney's fees and legal expenses, which expenditures were the direct means of the production of most of the income against which the deficiency is asserted, were ordinary and necessary expense of carrying on the business, and therefore deductible. This is true whether respondent's business be viewed as a lawful, or an unlawful, business.

In the instant case the elements of admission of guilt or consent, as by decree, are wholly absent. Here the respondent, at every stage, resisted the issuance and execution of the "fraud order" and in so doing exercised every remedy available to him in the law.

In *Textile Mills Corporation* v. *Commissioner*, 314 U. S. 326, relied upon by petitioner, this Court held that under

Section 23 (a) as construed by Article 262 of Treasury Regulation 74, the taxpayer was not entitled to deduct from income the expenses of lobbying and disseminating propaganda, paid by the taxpayer to bring about enactment of legislation authorizing recovery of German properties seized during World War I. Article 262 of Treasuary Regulation 74, provided in part as follows:

> "Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income."

The Court held that the Regulation was a proper exercise of the rule-making authority of the Treasury Department, and, accordingly, disallowed as a deduction the expenditures for lobbying and propaganda. It is clear that the Court so decided because the deduction was expressly prohibited by the Regulation. In the instant case there is no Article of the Treasury Regulations construing Section 23 (a) as prohibiting deduction of attorney's fees and legal expenses paid under circumstances such as are here present. This fact alone distinguishes the *Textile Mills Corp.* case. The instant case does not involve expenses for lobbying or propaganda. Manifestly, it can not reasonably be said to be against public policy for a taxpayer to employ attorneys to exercise legal remedies made available to him by the law of the land.

The case of *Standard Oil Co.* v. *Commissioner*, 129 Fed. (2d) 363, does not support petitioner. In that case the payment of a tort judgment entered against the taxpayer in favor of the Government, was held not deductible because the Court concluded after a careful study of the record, *that the said judgment was an adjudication that*

the taxpayer had been guilty of corrupting public officials and of perpetrating fraud upon the Government. (See p. 371 of report.) Certainly it cannot be seriously argued that expense incurred by the employment of attorneys in exercising legal remedies provided by law as in the instant case, is to be placed in the same category as the payment of a judgment based upon a fraud against the Government and the corruption of public officials by the taxpayer.

In *National Outdoor Advertising Bureau* v. *Helvering*, 89 F. (2d) 878, cited by petitioner, the taxpayer incurred legal expenses in defending against charges of violation of the Sherman Act. As to a part of the charges, the taxpayer defended successfully. As to the balance, it agreed to a consent decree. The taxpayer sought to deduct attorney's fees paid in this litigation. The Circuit Court of Appeals approved a deduction of the attorney's fees paid in defending the charges upon which the consent decree was silent, but denied the deduction of legal expenses paid in negotiating the settlement and drafting of the consent decree. It is worthy of note that this decree was entered with the *consent* of the defendant. The consent was a clear recognition by the defendant that the practices complained of would be unlawful in the future and that such practices had been unlawful in the past. The decree was an *adjudication* by the Court of defendant's unlawful conduct in connection with a lawful business. The instant case does not involve the elements of *adjudication* and *consent;* likewise it does not involve a business having separable activities.

Notwithstanding these distinguishing elements in the instant case we submit that the *National Outdoor Advertising* case is manifestly unsound in its conclusion. This is clearly apparent when the doctrine of that case is ap-

plied to an illegal and prohibited business. In an unlawful business, the illegal conduct is basic and pervades all that is done. No basis exists for finding a lack of proximate relation between the business expenses, on the one hand, and the conduct of the unlawful business, on the other hand. In such a case, it cannot logically be asserted that the unlawful conduct is unnecessary. If the case of *National Outdoor Advertising Bureau* v. *Helvering* properly construes Section 23 (a) then logically it must follow that no expense whatever of conducting an unlawful business is deductible, and the tax must fall upon the gross receipts of such a business. Manifestly, that is not the law. The tax is imposed upon the net income of the taxpayer, not gross receipts. By the Revenue Acts of 1936 and 1938 Congress taxed only net income remaining after deduction of all ordinary and necessary expenses of carrying on the business.

Another group of cases cited by respondent involved attempts by taxpayers to deduct payments which had been exacted by the law as punishment for unlawful conduct. *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 Fed. (2d) 990, penalties imposed for violation of the Federal Safety Appliance laws and other statutes; *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 Fed. (2d) 178 (C. C. A. 2d), concerned fines; *Great Northern Ry. Co.* v. *Commissioner*, 40 Fed. (2d) 373 (C. C. A. 8th), and *Tunnel R. R.* v. *Commissioner*, 61 Fed. (2d) 166 (C. C. A. 8th) concern penalties for violation of Federal statutes and regulations relating to the operation of railroads; *United States* v. *Jaffray*, 97 Fed. (2d) 488, involved negligence penalties imposed under the income tax laws.

We believe that in the cases mentioned above the Courts correctly disallowed deductions of the fines and penalties,—payments which had been required by the law to

punish and deter unlawful conduct. The result would be anomalous indeed if, after such punishment, the law were to grant to a taxpayer a substantial tax benefit by permitting him to deduct such fine or penalty from his income. However, the present case does not involve any question of deducting expenditures for fines or penalties. It concerns amounts paid by petitioner for attorneys' fees and legal expenses in exercising remedies provided by the law. Accordingly, there exists no comparable reason, resting on considerations of public policy, for refusing petitioner the right to deduct his said expenditures.

For the most part, the remainder of the cases cited by respondent involved attempts to deduct payments, the act of making which involved conduct either unlawful or offensive to public morale. *Maddas* v. *Commissioner*, 40 B. T. A. 572, affirmed, 114 Fed. (2d) 548 (C. C. A. 3), concerned bribes paid to prohibition agents; *Silberman* v. *Commissioner*, 44 B. T. A. 600, concerned payments for maintaining an illegal betting booth prohibited by state law; *Kelley-Dempsey & Co.* v. *Commissioner*, 31 B. T. A. 351, involved graft payments; *Easton Tractor & Equipment Co.* v. *Commissioner*, 35 B. T. A. 189, and *New Orleans Tractor Co.* v. *Commissioner*, 35 B. T. A. 218, involved payments by contractors to gain personal influence with State highway departments; *Nicholson* v. *Commissioner*, 38 B. T. A. 190, concerned a payment made to influence a State Senator; *Rugel* v. *Commissioner*, 127 Fed. (2d) 393, involved a sum paid to gain wrongful political influence.

In the cases mentioned above, the deductions were correctly disallowed for reasons of public policy. Certainly, one who seeks to corrupt public officials or improperly to gain political influence or to escape the consequences of

dishonest performance of public contracts, should not be granted a tax benefit because of such a payment. Such expenditures are not ordinary and necessary business expenses. However, the present case does not involve deduction of any amount paid as a bribe, or as a graft, or to gain political influence. This case involves the sole question whether respondent is entitled to deduct the amounts which he expended for attorneys' fees and legal expenses in exercising his legal remedies. Obviously, the cases referred to above afford no support for petitioner's position.

The petitioner contends that because the permanent injunction granted respondent in the District Court, was ultimately dissolved by the United States Court of Appeals, that therefore the legal expense incurred by respondent was incurred in an unsuccessful action. True, the action ultimately failed but for a considerable time and to a great extent it was successful—successful to the extent that it was the direct means of producing a substantial portion of respondent's income in the year 1937 and all of his income in the year 1938. In this respect the instant case presents a completely different factual situation than appears in any of the authorities cited by petitioner.

CONCLUSION.

Whether respondent's business be viewed as a lawful or an unlawful business, in either case it was either lawful or unlawful in its entirety; it had no separable phases or activities. In either case, under the statutes, the regulations issued thereunder and the authorities construing the same, the tax is upon *net* income, and these deductions should be allowed. It is clear from the facts in this case that the attorneys' fees and legal expense incurred by respondent were "ordinary" and "necessary" to the "carrying on" of respondent's business and that the income produced by the business was the direct result of those expenditures. We respectfully submit that the decision here of the Circuit Court of Appeals for the Seventh Circuit is in all respects sound and correct and should be sustained.

Respectfully submitted,

FLOYD LANHAM,
Attorney for Respondent.

APPENDIX.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * * *

Section 23 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 477, is identical with Section 23 (a) of the Revenue Act of 1936, *supra*.

Revised Statutes:

SEC. 3929, as amended.—The Postmaster General may, upon evidence satisfactory to him that any person or company is engaged in conducting any lottery, gift enterprise, or scheme for the distribution of money, or of any real or personal property by lot, chance, or drawing of any kind, or that any person or company is conducting any other scheme or device for obtaining money or property of any kind through the mails by means of false or fraudulent pretenses, representations, or promises, instruct postmasters at

any post office at which registered letters or any other letters or mail matter arrive directed to any such person or company, or to the agent or representative of any such person or company, whether such agent or representative is acting as an individual or as a firm, bank, corporation, or association of any kind, to return all such mail matter to the postmaster at the office at which it was originally mailed, with the word "Fraudulent" plainly written or stamped upon the outside thereof; and all such mail matter so returned to the writers thereof, under such regulations as the Postmaster General may prescribe. Nothing contained in this section shall be so construed as to authorize any postmaster or other person to open any letter not addressed to himself. The public advertisement by such person or company so conducting such lottery, gift enterprise, scheme, or device, that remittances for the same may be made by mail to any other person, firm, bank, corporation, or association named therein shall be held to be prima facie evidence of the existence of said agency by all the parties named therein; but the Postmaster General shall not be precluded from ascertaining the existence of such agency in any other legal way satisfactory to himself." (U. S. C., title 39, Sec. 259.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (a)—1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * *. Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 23 (a)—2), advertising and other selling expenses, together with

insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

Article 23 (a)—1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, is identical with Article 23 (a)—1 of Treasury Regulations 94, *supra*.

No. 63.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1943.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

S. B. HEININGER, *Respondent.*

On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

BRIEF OF AMICUS CURIAE.

HENRY J. RICHARDSON,
Amicus Curiae.

JOHN LEWIS KELLY,
Of Counsel.

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BRIEF OF AMICUS CURIAE.

This brief, with the consent of counsel for both parties, is filed by the undersigned as *amicus curiae* because the decision of the case will control or influence the decisions of many other cases which involve a kindred question, in some of which the undersigned is interested as counsel.

QUESTION INVOLVED.

The question involved in the instant case is whether legal expenses incurred in opposing a fraud order issued by the Post Office Department against the taxpayer are deductible for income tax purposes, or are to be disallowed solely

because the final outcome of the litigation in which said expenses were incurred was against said taxpayer.

STATEMENT.

The facts have been fully stated in the brief for petitioner and respondent.

SUMMARY OF ARGUMENT.

The revenue laws are enactments to raise money by taxing individuals, trusts, associations and corporations on net income as defined by law and not on their gross income.

There are no statutory limitations on the deduction of legal expenses under section 23(a) of the Revenue Acts of 1936 and 1938 based on the outcome of litigation in which the legal expenses were incurrd.

Only in an extreme case is the doctrine of "public policy" as a judicial limitation on the deduction of expenses otherwise allowed by section 23(a) warranted, and the case at bar is not such a situation.

ARGUMENT.

1. The Revenue Laws are Enactments to Raise Money by Taxing Individuals, Trusts, Associations and Corporations on Net Income as Defined by Law and Not on Their Gross Income.

The elemental point stated requires, of course, no citation in support of its fundamental correctness. But it is a reminder that while some may argue as to the scope of the Sixteenth Amendment, even to claiming that it permits the taxation of gross income, nevertheless, the Congressional scheme of taxation is confined to taxing net income, and the denial of deductions allowed by statute in determining net income amounts to the taxation of gross income contrary to the statutory plan, no matter what legalistic basis or "public policy" may be said to sanction such interpretation.

Petitioner, as an introductory argument in his brief, states (P. B. p. 6):

> At the very outset it should be borne in mind that, since deductions from gross income are a matter of legislative grace, the taxpayer has the burden of establishing his right to the deduction. *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *White* v. *United States*, 305 U. S. 281, 292.

The Court may be interested in an answer to such an argument which comes from the pen of Professor Erwin N. Griswold, and is to be found in a commentary published in June of this year entitled "An argument against the doctrine that deductions should be narrowly construed as a matter of legislative grace." 56 Harvard Law Review 1142.

Professor Griswold initially points out in his note that in *Gould* v. *Gould*, 245 U. S. 151 (1917) the rule was laid down, which taxpayers have often cited, that in case of doubt taxing statutes "are construed most strongly against the Government and in favor of the citizen." He then shows that *White* v. *United States*, 305 U. S. 281, 292 (1938) ended the influence of the cited passage from *Gould* v. *Gould*, *supra*. He then comments as to the citation given by petitioner from this Court's opinion in the *New Colonial Ice Co.* case as follows:

> Meanwhile, however, another aphorism has grown up which seems directly analogous to the rule of *Gould* v. *Gould* and equally unsound. This is to be found in the recent decision of the Supreme Court in Interstate Transit Lines v. Comm'r [decided June 1943], where the Court refers, as the keystone of its opinion, to "the now familiar rule that an income tax deduction is a matter of legislative grace and the burden of clearly showing the right to the claimed deduction is on the taxpayer." This rule in its strict form is of very recent origin. Apparently the first expression in terms of "legislative grace", is found in *New Colonial Ice Co.* v. *Helvering* [292 U. S. 435, 440 (1934)]. There may be some reason to think that the statement there had its roots in the group of cases involving depletion

in the primitive stages of our tax laws. For the most part, though, the earlier cases involving deductions seem to have gone no further than a statement of the burden of proof which generally lies on taxpayers. But the sweeping rule of the *New Colonial Ice* case has since been frequently cited or quoted. An indication of the potency of this approach to the construction of deduction provisions may possibly be found in the fact that the decisions in all but one of these cases went against the taxpayer.

Although the *New Colonial Ice* formula is a "now familiar rule" and is cited by Government lawyers in their briefs as glibly as taxpayers' lawyers once relied on *Gould* v. *Gould*, it has never been fully considered by the Court. Taken literally, it would mean that Congress may deny all deductions and impose a tax on gross income. This is a large question about which there may be reasonable doubts, even today. Could Congress, for example, impose the tax on the entire proceeds from the sale of property without any allowance for the cost of the property? Could it deny deductions for all wages paid? But there is no need to resolve such questions, nor to deny that Congress has very great power over the deductions which are allowed. *The fact remains that Congress has never sought to tax gross income*, and the whole structure and history of the income tax makes it plain that the intention of Congress to allow deductions has been just as clear as its intention to tax income.

2. There are no Statutory Limitations on the Deduction of Legal Expenses Under Section 23(a) of the Revenue Acts of 1936 and 1938 Based on the Outcome of Litigation in Which the Legal Expenses Were Incurred.

Professor Griswold in the note cited and quoted from previously makes some other comments on the deduction of ordinary and necessary expenses generally. Some of these remarks are as follows (56 Harvard Law Review 1142, 1145):

> There would seem to be room to think that the approach exemplified by the passage from the *New*

Colonial Ice case has already resulted in considerable distortion of our income tax law. Much of the controversy has revolved round the matter of deductions for business expenses.

The statute allows the deduction of "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .". This language has been unchanged since the Revenue Act of 1918. Apparently it finds its origin in provisions which were included in the Act of August 27, 1894. The legislative history of these provisions gives clear evidence that they were intended to have broad application; and no action of Congress since that time has ever indicated a contrary intention. There would seem to be every reason why the words of the statute should be given a broad construction so as to achieve the obvious purpose of Congress to tax net business income. It is true that the expenses must be "ordinary and necessary" but these words are given full and adequate function when they are used to separate capital expenditures from current expenses, on the one hand, and when they eliminate such things as illegal expenditures or wholly unrelated expenses, on the other. But the Court, by bearing down on "ordinary and necessary" and on "trade or business" and reducing these phrases to sterile bones, has done much to thwart the purpose of Congress to impose the tax on net incomes.

While some provisions of the revenue laws may be aimed at the indirect accomplishment of some social, economic or political purpose, nevertheless the statutory provisions are not texts on morals and have as a primary objective the function of taxing net income. Judge Sibley of the Fifth Circuit, in *Alexandria Gravel Co.* v. *Commissioner*, 95 F. (2d) 615, put these thoughts this way (p. 616):

> The revenue laws of the United States are not over-squeamish. By the broad definition of gross income, income arising from an illegal business is taxed even though the illegality be one declared by the Constitution itself. *United States* v. *Sullivan*, 274 U. S. 259. The provisions of the statute fixing the deductions to be regarded in arriving at the net income which alone

is taxed, 26 U. S. C. A. §23, are as broad and unqualified as those defining the taxable gross income.

The deduction of legal expenses is within or without these twenty words of section 23(a) of the Revenue Acts of 1936 and 1938 which permits the deduction from gross income of—

> "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ."

There are no words of limitation in the foregoing statutory language limiting the deduction of legal or other expenses based on the outcome of litigation. Any limitation on the deduction of legal expenses paid or incurred during a taxable year of one carrying on a trade or business must be—

(a) by way of a particular construction placed upon the words "ordinary and necessary" or

(b) by reading into the statutory language the word "lawful" before the words "trade or business" thus limiting deductions to those incurred in lawful trades or businesses.

As to (b) above, the case of *United States* v. *Sullivan*, 274 U. S. 259, 47 S. Ct. 607, 71 L. Ed. 1037, 51 A. L. R. 1020, stands in the way of reading the word "lawful" before the words "trade or business" even constructively. That case held that although the taxpayer was engaged in a business which violated the National Prohibition Act his net income was subject to taxation. It was pointed out at 274 U. S. 263 that gains or profits "of any business" were taxed. Moreover it was pointed out that in section 213(a) of the Revenue Act of 1921 defining income and the provision then before the court, the definition was similar to that of the earlier Act of October 3, 1913 (c. 16 Section II, B, 38 Stat. 114, 167) "except that the word 'lawful' is

omitted before 'business' in the passage just quoted." Thus Congress showed its intention to tax the income from unlawful as well as lawful businesses. Consequently ordinary and necessary expenses of an unlawful business would be deductible under the statutory scheme of taxing only net income. *Steinberg* v. *United States*, 14 F. (2d) 564.

It is apparent from this bit of income tax history that it cannot now be said either that the income from unlawful businesses is not taxable or that deductions from the income of such businesses are to be denied. The one question left open in *United States* v. *Sullivan*, *supra*, in the matter of deductions from gross income was the deduction of such an expenditure as for bribery, which conceivably might be denied as being against public policy. Bribery is not involved in the case at bar, nor was lobbying, which was the subject matter involved in *Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326, 62 S. Ct. 272.

To hold that legal expenses will be deductible only if a taxpayer is vindicated from some alleged violation of law is to impose a penalty upon defending oneself which is not in keeping with American traditions of encouraging the employment of counsel and presenting ones case to an impartial tribunal.

In *Kornhauser* v. *United States*, 276 U. S. 145, 48 S. Ct. 219, this Court in holding that fees paid to attorneys for defending an action for accounting instituted by a former partner was deductible, said (p. 152)—

> * * * it was an "ordinary and necessary" expense, since a suit ordinarily and, as a general thing at least, necessarily requires the employment of counsel and payment of his charges * * *

In discussing the grounds for such deductions it was said—

> The basis of these holdings seems to be that where a suit or action against a taxpayer is directly con-

> nected with, or as otherwise stated (Appeal of Backer, 1 B. T. A. 214, 215) proximately resulted from, his business, the expense incurred is a business expense within the meaning of section 214 (a) subd. 1, of the act.

It is submitted that *Kornhauser* v. *United States* still states sound principles of tax law. Where legal expenses are incurred which are directly connected with a business they are ordinary and necessary expenses of that business and are, therefore, deductible. To read into the statutory concept a limitation on such deductions based on the outcome of litigation is not only unwise but unwarranted. Congress has not changed the text of section 23(a) as to the deduction of "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." since this language was put in the Revenue Act of 1918 as section 214(a) which is the provision interpreted in the *Kornhauser* case.

While we have this Court's reference to the meaning of "ordinary and necessary" in *Welch* v. *Helvering*, 290 U. S. 111, 54 S. Ct. 8, and *Deputy* v. *du Pont*, 308 U. S. 488, 60 S. Ct. 363, it is to be noted that what constitutes "ordinary and necessary" expenses has not been circumscribed by a decision of this Court or in any regulation by the qualification that the deduction of such expenditures may depend upon the outcome of litigation and Congress has imposed no such limitation.

The Court below, in the case at bar, pointed out that—

> We are asked, in the guise of construing the words "ordinary and necessary" to amend the statute. In other words, to engage in a little judicial legislation. We decline the invitation.

Other courts have also refused "to engage in a little judicial legislation" (*Foss* v. *Commissioner*, C. C. A.—1, 75 F. (2d) 376) but not so the Second Circuit, which accepted the invitation extended in *Burroughs Bldg. Mate-*

rial Co. v. *Commissioner*, 47 F. (2d) 178, and has continued to do so through *National Outdoor Advertising Bureau* v. *Helvering*, 89 F. (2d) 881.

The rationale of *National Outdoor Advertising Bureau* v. *Helvering*, in denying a deduction in part for certain legal expenses, was that it was not a necessary expense, thus not within the requirement of §23(a) but presumably an ordinary one since the court did not attempt any rationalization on this point. The theory that such legal expenses were not necessary was not precisely stated in the opinion. The closest approach to such a statement seems to be the following excerpt:

> If it is never necessary to violate the law in managing a business, it cannot be necessary to resist a decree in equity forbidding violations, except in cases where an injunction is unjustified. There is indeed less to be said for spending money in that way than in defending a criminal prosecution for the decree by hypothesis will do no more than forbid what the taxpayer ought not to do anyway. Moreover, when as here, the decree is entered in a suit by the United States, there would seem to be all the elements of an estoppel; and, that aside, the consent is an acknowledgment of the proximity of the danger, as we have already said.

Many arguments against the rule of *National Outdoor Advertising Bureau* v. *Helvering* may be cited; it also may be scored as a poorly worked out judicial limitation on the deduction of legal expenses. The following comment from 54 Harvard Review 852, 855, seems to be one proper criticism of the rule of the cited case for it is pointed out that—

> • • • several courts have evolved the reasoning that it is unnecessary to defend any action by the government if you are guilty; any money expended in so doing is wasted, and therefore not "necessary" [citing *National Outdoor Advertising Bureau* v. *Helvering*]. But this fallaciously assumes a mechanical jurisprudence in which one can predict with certainty how cases will be decided; the taxpayer must be gifted with

a foresight which is not generally required by the current judicial definition of "necessary." Therefore these decisions must be justified if at all by a broad public policy similar to that underlying the disallowance of fines and penalties. However, the amount of the fine is an expression of what the exaction for wrongdoing should be, and disallowance may be necessary to make the taxpayer actually bear the burden of the fine. But this does not apply to legal expenses, and since legal fees may often be many times larger than the fine, the effect will be to invoke an additional penalty for wrongdoing completely unrelated in dollar amount to the statutory exaction.

An additional difficulty in disallowing expenditures which reflect the cost of wrongdoing is that an arbitrary line is drawn between actions by the government and actions by individuals. Thus expenses resulting from the unsuccessful defense of such torts as fraud, negligence, malpractice, breach of fiduciary duty, and patent infringements may be deducted. It has been said that torts are a necessary incident of modern business life, while statutory violations are not; and it may be that there is less public necessity in deterring wrongs redressed by civil actions; yet such generalities hardly justify such an arbitrary rule of law.

The rule of *National Outdoor Advertising Bureau* v. *Helvering*, that where a criminal prosecution under the Sherman Anti-Trust Act ends in a consent decree only the cost of defending so much of the case as the prosecution is not successful, is deductible, has been criticised on other grounds. For example, in the most recent edition of Mertens "Law of Federal Income Taxation" (1942 Ed.) the rule of the cited case has been scored on the ground that "Where the issue is settled by a consent decree, such decree may frequently deal with matters not directly connected with the criminal prosecution." (Vol. 4, p. 385) In support of this statement the following note appears:

> See, e. g., U. S. v. Ford Motor Co., et al. CCH Trade Regulation Service, Par. 25,171. In addition it overlooks the practical aspect that taxpayers may

consent to decrees because of the cost of defending the criminal action, because they are not doing and do not intend to do the acts covered by the decree and hence are willing to be enjoined. The suggestion that the consent to the decree means that there was an appreciable possibility that the enjoined acts would be done is unrealistic in many cases.

With the present number and complexity of federal and state statutes and rules and regulations promulgated thereunder having the force and effect of law, no business could be transacted if business men in this country had to get clearance from counsel on each and every decision they wish to make. Yet every decision made, every operation undertaken, raises the possibility of a violation of one or another of the myriad laws and regulations or amendments thereto. One can review with profit this situation a little further. This Court may well take judicial notice of the fact that prior to the establishment of the Federal Register Act of July 26, 1935 (49 Stat. 500 as amended; 44 U. S. C. ch. 8B) Congress found that people were being charged with the violation of all kinds of rules, regulations and orders that they not only never heard of but could not find in print. Yet if such a person had employed counsel to defend themselves in the ordinary and necessary course of their business but it turned out that under some obscure regulation having the force and effect of law they had violated such regulation, then under the rule contended for by petitioner in this case such legal expense would not be deductible, but if it had been ruled that no violation of said regulation had occurred, then the legal expenses incurred would have been deductible.

Here is another situation existing today. Examine a copy of the Federal Register of any date and it will be noticed that in many instances many of the war agencies such as the W. P. B., O. P. A. and even "old line" departments, are not only issuing new rules and regulations daily but that they are so constantly amending existing regula-

tions that it is almost impossible to tell from day to day just what the law is in relation to a given point and therefore impossible for counsel to advise what is and what is not permissible under the law of the land. Thus over the head of every ordinary business enterprise in the country there is the lurking possibility of a charge of the violation of one or another rule or regulation. Again, the defense of such a charge will not constitute a deductible expense under the rule contended for by petitioner in this case if by any chance the taxpayer violated such rule or regulation.

Again, the rule urged by petitioner is not realistic in the light of the following situation: A reputable manufacturer and distributor in advertising its products, let us say, makes certain claims which the Federal Trade Commission believes unjustified in the light of their investigations and accordingly they charge the concern with "unfair practice in commerce" under the Federal Trade Commission Act. The advertiser disagrees with the Commission's viewpoint and accordingly counsel is employed to defend it. Let us further suppose that the point in issue is a very close one requiring considerable expert testimony because there is a considerable variance in the opinion of scientific men on the question involved. After the array of witnesses and other evidence has been placed before the Commission a decision in due course will be rendered which can only be overturned in the federal courts if there is no substantial evidence in support thereof. Based on its decision in such a close case as that outlined, the rule contended for by petitioner would deny a deduction for legal expenses to a taxpaper to the extent that the decision of such a tribunal was against the contentions of the taxpayer or resulted in a stipulation of revised practices—consent decree.

The recent language of Judge Learned Hand in the *Associated Press* decision (New York Times, October 7, 1943) points up very clearly the harshness in the narrow

interpretation which the petitioner proposes be given to the term "ordinary and necessary" in relation to deductible business expenses. In the *Associated Press* case, the complaint alleged the existence of a combination in restraint of interstate commerce. But as Judge Hand pointed out, not only must there be a restraint but it must be unreasonable—

> * * * and that never has been, and indeed in the nature of things never can be, defined in general terms.
>
> Courts must proceed step by step applying retroactively the standard proper for each situation as it comes up * * *. Decision in each case depends upon a comparative appraisal of the values of the object sought to be accomplished by the actors' conduct, the effects of such conduct and of the object on competition and on business enterprise, and the opposing interests of the actors in freedom of action and of the person harmed in freedom of opportunity to do business. * * *
>
> Certainly such a function is ordinarily "legislative." * * * We have here a legislative warrant, because Congress has incorporated into the anti-trust acts the changing standards of the common law, and by so doing has delegated to the courts the duty of fixing the standard for each case.

As Judge Hand points out, decisions of courts or administrative tribunals as to the legality of acts challenged under the broad scope of present day legislative prohibitions are in effect retroactive legislative enactments applied to the particular case in dispute. When a transaction which has been carried out in good faith to further the interests of a business enterprise is challenged as being subject to the impact of the process described by Judge Hand, clearly the expense of meeting that challenge is an ordinary and necessary expense of the business; the retroactive process should not further be extended to change this classification depending upon the conclusion reached by a court or an administrative body, frequently by divided

vote, as to the legality of the transaction. The legislative policy which, in the case of an administrative body, makes such a conclusion binding and not subject to reversal if supported by any substantial evidence, regardless of the weight of the evidence considered as a whole, further underlies the importance of not reading into the tax law the limitations here urged by the petitioner.

The law recognizes that those accused of violating its provisions are entitled to counsel; even in the case of confessedly guilty parties, public policy encourages the retention of counsel to see that the requirements of due process are complied with and that a correct application of the law's provisions has been made. It is inconsistent with this policy to hold that an unsuccessful defense by a business enterprise of its way of life is not an ordinary and necessary expense when, as in most instances, it is impossible, in advance of a decision of some tribunal, to prophesy whether taxpayer's conduct will be found to be on one side or the other of what is ultimately determined to be lawful.

In view of the multiplicity of restrictive legislative and administrative regulations affecting business, the uncertainties arising from the lack of exact definitions in the controlling standards, the difficulty of construing new statutes and regulations, and the possibility of technical violations, despite the utmost good faith and the support of most reputable authority, the rule contended for by the petitioner in this case would place an unbearable burden on the conduct of business. Under present-day tax rates, business may well be unable to properly defend itself if this must be done at the risk of having the expense disallowed.

There is nothing in the tax law which requires any such harsh result. The statute permits the deduction of "ordinary and necessary" expenses. A reasonable interpretation of this provision does not require that a business man, who, in the conduct of his enterprise, in good faith

takes some action which a court or administrative body may later decide to be within a prohibited area, be placed in the same category as a giver of bribes.

Only in an extreme case is the doctrine of "public policy" as a judicial limitation on the deduction of expenses otherwise allowed by section 23(a) warranted, and the case at bar is not such a situation. The deduction of legal expenses does not stand on the same footing, for example, as the payment of bribes or of lobbying expenses which this Court considered in the *Textile Mills Securities Co.* case, *supra.* Nor are such expenses in the same class as fines and penalties, as is pointed out in 12 Fordham Law Review 8 (January 1943), where it was said (p. 19):

> The soundness of the decisions which disallow as deductions fines and penalties, whether imposed for innocent mistake or for serious infractions, is not questioned. A fine or a money penalty is a form of punishment, and public policy demands that the offender bear the full brunt of it. To allow an income tax deduction for a fine would place the Government in the anomalous position of itself bearing a portion of the burden. But this is not so as to the incidental legal expenses. Does public policy in all cases require that since fines are disallowed, legal expenses in litigating the question of liability therefor should also be disallowed? If one abandon the role of idealist, and realistically approach the problem of squaring the complexities of the conduct of present day industrial business with the countless technical provisions of existing regulatory laws, each with its concomitant fine or penalty, one is less inclined to insist upon that brand of logic which demands that since a fine is non-deductible, legal expenses incident to the determination of liability therefor must likewise be disallowed, and which further demands that until the question of liability for the fine is determined, the question of the deductibility of the legal expenses must remain in abeyance.

Still another distinction may be made between the disallowance of fines and penalties as a matter of public pol-

icy as contrasted with the disallowance of legal expenses. Fines and penalties which find their sanction in federal laws represent the expressed will of Congress that a penalty shall be levied for certain acts. However, when a court disallows a tax deduction for legal expenses because of an unsuccessful defense of some act, the court is, in effect, also levying another fine or penalty, and this without the sanction of Congress. Again Congress may have deliberately avoided providing any fine in connection with the act restrained; to deny legal expense in defending and determining the legality of the act would be to supply the fine which Congress refrained from imposing.

It may thus be seen that resort to the doctrine of "public policy" as a basis for the disallowance of a deduction should be very limited. It is indeed a very unusual case where there is any justification for the application of this doctrine and certainly the case at bar is not such a situation.

Respectfully submitted

HENRY J. RICHARDSON,
Amicus Curiae.

JOHN LEWIS KELLY,
Of Counsel.

SUPREME COURT OF THE UNITED STATES.

No. 63.—October Term, 1943.

Commissioner of Internal Revenue, Petitioner, vs. S. B. Heininger.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[December 20, 1943.]

Mr. Justice Black delivered the opinion of the Court.

The question here is whether lawyer's fees and related legal expenses paid by respondent are deductible from his gross income under Section 23(a) of the Revenue Acts of 1936 and 1938 as ordinary and necessary expenses incurred in carrying on his business.[1]

The fees and expenses were incurred under the following circumstances. From 1926 through 1938 respondent, a licensed dentist of Chicago, Illinois, made and sold false teeth. During the tax years 1937 and 1938 this was his principal business activity. His was a mail order business. His products were ordered, delivered, and paid for by mail. Circulars and advertisements sent through the mail proclaimed the virtues of his goods in lavish terms. At hearings held before the Solicitor of the Post Office Department pursuant to U. S. C. Title 39, §§ 259 and 732, respondent strongly defended the quality of his workmanship and the truthfulness of every statement made in his advertisements, but the Postmaster General found that some of the statements were misleading and some claimed virtues for his goods which did not exist. Thereupon, on February 19, 1938, a fraud order was issued forbidding the Postmaster of Chicago to pay any money orders drawn to respondent and directing that all letters addressed to him be stamped "Fraudulent" and returned to the senders. Such a

[1] Revenue Act of 1936, c. 690, 49 Stat. 1658.
"Sec. 23. Deductions from Gross Income.
"In computing net income there shall be allowed as deductions:
"(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ."
Section 23(a) of the Revenue Act of 1938, c. 289, 52 Stat. 460, is identical with Section 23(a) of the Revenue Act of 1936.

sweeping deprivation of access to the mails meant destruction of respondent's business. He therefore promptly sought an injunction in a United States District Court contending that there was no proper evidential basis for the fraud order. On review of the record that Court agreed with him and enjoined its enforcement. The Court of Appeals drew different inferences from the record, held that the evidence did support the order, and remanded with instructions to dissolve the injunction and dismiss the bill. *Farley* v. *Heininger,* 105 F. 2d 79. Respondent's petition for certiorari was denied by this Court on October 9, 1939. *Heininger* v. *Farley,* 308 U. S. 587.

During the course of the litigation in the Postoffice Department and the courts respondent incurred lawyer's fees and other legal expenses in the amount of $36,600, admitted to be reasonable. In filing his tax returns for the years 1937 and 1938 he claimed these litigation expenses as proper deductions from his gross receipts of $287,000 and $150,000. The Commissioner denied them on the ground that they did not constitute ordinary and necessary expenses of respondent's business. The Board of Tax Appeals[2] affirmed the Commissioner, 47 B.T.A. 95, and the Circuit Court of Appeals reversed and remanded. 133 F. 2d 567. We granted certiorari because of an alleged conflict with the decisions of other circuits.[3]

There can be no doubt that the legal expenses of respondent were directly connected with "carrying on" his business. *Kornhauser* v. *United States,* 276 U. S. 145, 153; cf. *Appeal of Backer,* 1 B.T.A. 214; *Pantages Theatre Co.* v *Welch,* 71 F. 2d 68. Our enquiry therefore is limited to the narrow issue of whether these expenses were "ordinary and necessary" within the meaning of Section 23(a). In determining this issue we do not have the benefit of an interpretative departmental regulation defining the application of the words "ordinary and necessary" to the particular expenses here involved. Cf. *Textile Mills Securities Corp.* v. *Commissioner,* 314 U. S. 326, 338. Nor do we have the benefit of the independent judgment of the Board of Tax Appeals. It did

[2] Section 504(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, 957. U. S. C. Title 26, § 1100 changes the name of the Board of Tax Appeals to "The Tax Court of the United States."

[3] Helvering v. National Outdoor Advertising Bureau, Inc., 89 F. 2d 878 (C.C.A. 2); Helvering v. Superior Wines & Liquors, Inc., 134 F. 2d 373 (C.C.A. 8).

not deny the deductions claimed by respondent upon its own interpretation of the words "ordinary and necessary" as applied to its findings of fact. Cf. *Hormel* v. *Helvering*, 312 U. S. 552, 555, 556. The interpretation it adopted was declared to be required by the Second Circuit Court's reversal of the Board's view in *National Outdoor Advertising Bureau, Inc.* v. *Commissioner*, 32 B.T.A. 1025.[4]

It is plain that respondent's legal expenses were both "ordinary and necessary" if those words be given their commonly accepted meaning. For respondent to employ a lawyer to defend his business from threatened destruction was "normal"; it was the response ordinarily to be expected. Cf. *Deputy* v. *du Pont*, 308 U. S. 488, 495; *Welch v. Helvering*, 290 U. S. 111, 114; *Kornhauser* v. *United States*, *supra*. Since the record contains no suggestion that the defense was in bad faith or that the attorney's fees were unreasonable, the expenses incurred in defending the business can also be assumed appropriate and helpful, and therefore "necessary." Cf. *Welch* v. *Helvering*, *supra*, 113; *Kornhauser* v. *United States*, *supra*, 152. The government does not deny that the litigation expenses would have been ordinary and necessary had the proceeding failed to convince the Postmaster General that respondent's representations were fraudulent.[5] Its argument is that dentists in the mail order business do not ordinarily and necessarily attempt to sell false teeth by fraudulent representations as to their quality; that respondent was found by the Postmaster General to have attempted to sell his products in this manner; and that therefore the litigation expenses, which he would not have incurred but for this attempt, cannot themselves be deemed ordinary and necessary. We think that this reasoning, though plausible, is unsound

[4] Helvering v. National Outdoor Advertisement Bureau, Inc., *supra*, Note 3. In that case the taxpayer had incurred legal expenses defending a suit begun by the United States to enjoin violations of the Sherman Act. It had successfully defended part of the charges against it, but had agreed to the entry of a consent decree of injunction as to the balance. The Board held that all of the legal expenses were ordinary and were proximately connected with the taxpayer's business, and that to allow them as deductions would not be against public policy. The Circuit Court reversed as to that portion of the expenses attributable to the consent decree. See also Helvering v. Superior Wines & Liquors, Inc., *supra*, Note 3, where the Board was reversed for allowing a taxpayer in the liquor business to deduct lawyer's fees incurred in connection with a compromise of liability for civil penalties assessed for improper bookkeeping under U. S. C. Title 26, §§ 2857 *et seq.*

[5] See Note 8, *infra*.

in that it fails to take into account the circumstances under which respondent incurred the litigation expenses. Cf. *Welch* v. *Helvering, supra,* 113, 114. Upon being served with notice of the proposed fraud order respondent was confronted with a new business problem which involved far more than the right to continue using his old advertisements. He was placed in a position in which not only his selling methods but also the continued existence of his lawful business were threatened with complete destruction. So far as appears from the record respondent did not believe, nor under our system of jurisprudence was he bound to believe, that a fraud order destroying his business was justified by the facts or the law. Therefore he did not voluntarily abandon the business but defended it by all available legal means. To say that this course of conduct and the expenses which it involved were extraordinary or unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world. Cf. *Welch* v. *Helvering, supra,* 115. Surely the expenses were no less ordinary or necessary than expenses resulting from the defense of a damage suit based on malpractice, or fraud, or breach of fiduciary duty. Yet in these latter cases legal expenses have been held deductible without regard to the success of the defense.[6]

The Bureau of Internal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in Section 23(a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct. A review of the situations which have been held to belong in this category would serve no useful purpose for each case should depend upon its peculiar circumstances.[7] A few examples will suffice to illustrate the principle involved. Where a taxpayer has violated a federal or a state statute and incurred a fine or penalty he has not been permitted a tax deduction

[6] Malpractice: C. B. V. 1, 226; Fraud: Helvering *v.* Hampton, 79 F. 2d 358; Breach of fiduciary duty: Isaac P. Keeler *v.* Commissioner, 23 B.T.A. 467. See also the examples of deductible expenses set forth in Kornhauser *v.* United States, 276 U. S. 145.

[7] For a collection and analysis of many of the cases see Note (1941) 54 Harv. L. Rev. 852; 4 Mertens, Law of Federal Income Taxation (1942) §§ 25.35-25.37, 25.102-25.105.

for its payment.[8] Similarly, one who has incurred expenses for certain types of lobbying and political pressure activities with a view to influencing federal legislation has been denied a deduction.[9] And a taxpayer who has made payments to an influential party precinct captain in order to obtain a state printing contract has not been allowed to deduct their amount from gross income.[10] It has never been thought, however, that the mere fact that an expenditure bears a remote relation to an illegal act makes it non-deductible. The language of Section 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible. And the brief of the government in the instant case expressly disclaims any contention that the purpose of tax laws is to penalize illegal business by taxing gross instead of net income. Cf. *United States* v. *Sullivan*, 274 U. S. 259.

If the respondent's litigation expenses are to be denied deduction, it must be because allowance of the deduction would frustrate the sharply defined policies of 39 U. S. C. §§ 259 and 732 which authorize the Postmaster General to issue fraud orders. The single policy of these sections is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal punishment on violators; such punishment is provided by separate statute,[11] and can be imposed only in a judicial proceeding in which the accused has the benefit of constitutional and statutory safeguards appropriate to trial for a crime. Nor is it their policy to deter persons accused of violating

[8] Great Northern Ry. Co. *v.* Commissioner, 40 F. 2d 372; Bonnie Bros., Inc. *v.* Commissioner, 15 B.T.A. 1231; Burroughs Bldg. Material Company *v.* Commissioner, 47 F. 2d 178; Appeal of Columbus Bread Company, 4 B.T.A. 1126. A taxpayer who has been prosecuted under a federal or state statute and convicted of a crime has not been permitted a tax deduction for his attorney's fee. Estate of Thompson *v.* Commissioner, 21 B.T.A. 568; Burroughs Bldg. Material Company *v.* Commissioner, *supra*. But if he has been acquitted, a deduction has been allowed. Commissioner *v.* People's-Pittsburgh Trust Co., 60 F. 2d 187; cf. Citron-Byer Co. *v.* Commissioner, 21 B.T.A. 308; Hal Price Headley *v.* Commissioner, 37 B.T.A. 738. Cf. Helvering *v.* Superior Wines & Liquors, Inc., *supra*, Note 3.

[9] Textile Mills Securities Corp. *v.* Commissioner, 314 U. S. 326, 338. Cf. Commissioner *v.* Sunset Scavenger Co., Inc., 84 F. 2d 453.

[10] Rügel *v.* Commissioner, 127 F. 2d 393. Cf. Kelley-Dempsey & Company *v.* Commissioner, 31 B.T.A. 351, where deduction was denied for the expense of commercial extortion.

[11] Criminal Code, Section 215; 25 Stat. 873; 35 Stat. 1130; U. S. C. Title 18, § 338.

their terms from employing counsel to assist in presenting a bona fide defense to a proposed fraud order. It follows that to allow the deduction of respondent's litigation expenses would not frustrate the policy of these statutes; and to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding which Congress has not expressly or impliedly indicated should result from such a finding. We hold therefore that the Board of Tax Appeals was not required to regard the administrative finding of guilt under 39 U. S. C. §§ 259 and 732 as a rigid criterion of the deductibility of respondent's litigation expenses.

Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances. Except where a question of law is unmistakably involved a decision of the Board of Tax Appeals on these issues, having taken into account the presumption supporting the Commissioner's ruling,[12] should not be reversed by the federal appellate courts.[13] Careful adherence to this principle will result in a more orderly and uniform system of tax deductions in a field necessarily beset by innumerable complexities. Cf. *Hormel* v. *Helvering, supra.* However, as we have pointed out above, the Board of Tax Appeals here denied the claimed deduction not by an independent exercise of judgment but upon a mistaken conviction that denial was required as a matter of law. We therefore affirm the judgment of the Circuit Court of Appeals reversing and remanding the cause to the Board of Tax Appeals.

Affirmed.

A true copy.

Test:

Clerk, Supreme Court, U. S.

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12 See Welch *v.* Helvering, 290 U. S. 111, 115.

13 Cf. Helvering *v.* F. & R. Lazarus & Co., 308 U. S. 252, 255; Dobson et al. *v.* Commissioner, Nos. 44-47, decided this day.